ofgem

Memo

DPCR5 workshop on Networks and Financial Issues

Record of the day and issues raised at workshop on 19 May 2008, Park Plaza Hotel, Victoria.

1. Attendance

Ofgem

Rachel Fletcher	Director, distribution
Nick Russ	Network investment
Simon Polley	
Ronke Adenuga	
Chris Watts	Cost & Outputs
Jake Wood	
Sofia Eng	
Mario Perrone	
Peter Rice	
Mark Cox	Distribution policy
Roger Morgan	
Nicola Cocks	Programme management
Paul Newman	
Sian Bailey	
Kieran Donoghue	Gas distribution
Paul Branston	
Gareth Evans	Technical

Stakeholders

Name		Organisation	
Wasif	Anwar	E.ON UK	
Yorgos	Aronis	EIB	
Paul	Barnfather	EA Technology Consulting	
Andrew	Barroso	Deloitte	Morning
Katherine	Bartlam	Central Networks (CN)	
Cecilia	Bjorkegren	Northern Gas Networks (NGN)	
Jonathan	Booth	Electricity North West (ENW)	
Alan	Broadbent	Scottish and Southern Energy (SSE)	Morning
Rodney	Brook	Sohn Associates	
Stéphane	Buemi	Financial Security Assurance (FSA)	Afternoon
Malcolm	Burns	Scottish and Southern Energy (SSE)	
Jim	Cardwell	CE Electric	
Paul	Delamare	EDF Energy	Afternoon
Sangeet	Dhanani	Lecg Limited	
Mike	Dixon	EDF Energy	Morning
Predrag	Djapic	SEDG	Morning
Peter	Dooley	Royal Bank of Scotland (RBS)	
Mark	Drye	CE Electric	
Stephen	Edds	Fitch Ratings Ltd	
Ian	Foster	Central Networks (CN)	Morning

Name		Organisation	
John	France	CE Electric	
Daniel	Gambles	Ernst & Young LLP	
Charles	Groom	CEPA	Afternoon
Philip	Gueorguiev	EIC	
Lynda	Haigh	Herbert Smith LLP	Morning
Julia	Haughey	EDF Energy	
Allan	Hendry	ScottishPower Energy Networks	
Barry	Hollinghurst	Western Power Distribution (WPD)	
Ceri	Hughes	Centrica	
Keith	Hutton	EDF Energy	
Anton	Krawchenko	Fitch Ratings Ltd	
Enese	Lieb-Doczy	Deloitte	Afternoon
Andrew	Lilico	Europe Economics	
Ken	Linge	CE Electric	
Eleanor	Lipsey	MBIA UK Insurance Limited	Afternoon
Gavin	MacFarlane	Fitch Ratings Ltd	
Victoria	Mattina	ES Pipelines	
Alasdair	McLay	Intelligent Utility Networks	
Jim	McOmish	ScottishPower Energy Networks	
Mike	Moseley	Morrison Utility Services	
Darren	Nelson	LECG Ltd	
Rob	O'Malley	Electricity North West (ENW)	
John	O'Sullivan	ESB Networks	
Bob	Parker	Western Power Distribution (WPD)	
Andy	Phelps	Energy Networks Association (ENA)	
Carole	Pitkeathley	Energywatch	Morning
Dragana	Popovic	Energy Networks Association (ENA)	Morning
David	Porter	KEMA Consulting Europe	
Arthur	Probert		
Sabrina	Ran	Fitch Ratings Ltd	
Geoffrey	Randall	Reckon LLP	Afternoon
Ed	Reed	Cornwall Energy Associates	
Richard	Roberts	EDF Energy	Afternoon
Charles	Ruffell	RWE Npower	Morning
Paul	Sherley	Centrica	
Matt	Skinner	Asset Management Consulting Limited	Morning
Neil	Smith	Central Networks (CN)	Afternoon
David	Speake	ES Pipelines	
Gareth	Spinner	Freedom Group	
Andrew	Stanger	ScottishPower Energy Networks	
Stephen	Topping	Europe Economics	
Donna	Townsend	ES Pipelines	
Tim	Tutton	Oxera	
Fiona	Upton	E.ON UK	
David	Walker	West Coast Energy Ltd	
Sam	Wardill	EDF Energy	Morning
Tim	Warham	Pöyry Energy Consulting	
Bob	Westlake	Wales & West Utilities (WWU)	
Paul	Whittaker	National Grid Gas (NGG)	
Jenny	Woodruff	Central Networks (CN)	Morning
Charles	Yates	Government and Infrastructure Advisory	Afternoon
Matthew	Young	PricewaterhouseCoopers LLP	

2. Introduction

Rachel Fletcher welcomed attendees to the workshop and gave an introductory presentation.

All of the presentations given at the workshop are available on the Ofgem website[1].

3. Morning Session – Networks

Presentations by stakeholders

The Networks session began with the following attendees delivering presentations.

1. Key issues for DPCR5 – Ofgem – Nick Russ
2. Development of output measurement – ENW – Jonathan Booth
3. Stakeholder engagement – EDF Energy – Keith Hutton
4. Resourcing – EDF Energy – Sam Wardill
5. FBPQ and building blocks – CE Electric – Mark Drye

Question and Answer

Scale of consumer interaction

One attendee asked whether Ofgem was intending to speak to both large and small households as part of the planned consumer interaction.

Rachel Fletcher (Ofgem) replied that we will be in contact with both but that the greater challenge will be to communicate with domestic users specifically.

Regression

One stakeholder asked whether it is too early to be discounting regression as a suitable tool for cost assessment as we need to go through the process first.

Mark Drye (CE Electric) believed that it is not too early to consider that regression may not be useful.

Distribution Costs

One attendee stated that distribution costs are not a large part of people's bill yet capex is increasing and so, as a result, are distribution costs to customers.

Mark Drye (CE Electric) suggested that if new infrastructure is needed then it is unfair not to reflect this in customer charges.

Convergence

One attendee asked to what degree convergence of approach might be expected.

Mark Drye (CE Electric) said that one issue with convergence is that you will never get full agreement from all parties, although this was no excuse not to seek convergence in some areas.

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[1] http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=22&refer=Networks/ElecDist/PriceCntrls/DPCR5

Keith Hutton (EDF Energy) suggested that convergence seems to be appropriate in the connections arena.

Roundtable discussions and feedback

Each table was then assigned questions to discuss. Following the discussions, each table was asked to deliver a five minute summary of their views. Outlined below is a brief summary of the views presented in response to each question.

Q1.Have we captured all the key lessons learnt from DPCR4 regarding cost assessment?

Three tables of stakeholders answered this question.

The first table suggested that:

- One issue for cost assessment is matching forecasts for DCPR5 with historic data. There is a risk of losing historic factors.
- There is a need to ensure transparency in detail.
- The consultation document contains a good level of detail but this needs to be maintained going forward.
- There is a need to trade-off between disaggregation and consistency of data.
- Incentive mechanisms must be introduced early on in the process.
- There is a need to consider how the RPI at 20 review will impact on future price controls.
- The group asked whether DPCR5 will provide stronger linkage between spend and outputs.
- They also asked how development of new and long term technologies fits into the current scheme.

The second table suggested that:

- Ofgem have identified the right lessons learnt but there is now a need to see how this will be taken forward.
- New issues will arise and will need to be assessed as and when they do.
- Benchmarking is a key issue and could be improved through:
    - more flexibility going forward,
    - more robust data points, and
    - more stress testing.
- Need to ensure that renewable and distributed energy are covered.
- We could look at international comparatives to understand how they assess themselves and why.

The third table summarised that:

- The key lesson is ensuring data consistency.

- We also need to ensure that we make the appropriate choice of drivers.
- We should consider whether cost leaders are worth emulating and whether they are sustainable enough.
- The building blocks need to be clear on capex and opex boundaries but there will be some interaction between blocks.
- DNOs currently see their allowance as a budget.
- We need to look at the assessment of risk and the certainty of RAV.

Q2. Is our building block approach to forecasting appropriate?

Two tables answered this question.

The first table summarised that:

- The suggested approach is a structured way of developing and judging methodology.
- We need to recognise that there are interactions between building blocks.
- It was suggested that we could looked at water companies for lessons learnt in similar work.

The second table suggested that:

- Each DNO should forecast on the right way forward and look to include good engagement and input from stakeholders.
- Ofgem should undertake comparative analysis and identify differences between DNOs on:
    - assumptions,
    - levels of risk, and
    - levels of investment
- It is difficult to define efficiency.

Q3. What is the scope for developing additional outputs measures and how can these be incorporated into the price control?

Three tables answered this question.

The first table of stakeholder suggested that:

- Rather than introduce new incentives, we could look to give longer term commitment to current incentives.
- One option would be to allow different exposures to risk for each of the DNOs.
- We could also allow for greater variation between DNOs in terms of delivering specific outputs.

The second table summarised that:

- DG is long lived and will take time to develop. We need to consider if a 5 year timeframe for DG incentives is appropriate.
- The DG incentive is complex and volatile and low levels of take up are not due to the DNO failing to provide connections to those requesting them. Planning permission takes a long time for some schemes.
- DNOs should be incentivised to be proactive.

The third table suggested that:

- One difficulty in developing additional output measures is that they may become confusing and even perverse behaviour.
- Fault rates could be split up in order to learn more from them.
- Keen to push hard on asset base risk.
- We need to decide how to measure customer service. This could continue to concentrate on customer interruptions, customer minutes lost and fault rates. We need to ensure that overall the package it focuses on issues that are important to customers.
- Measures need to be added for environmental issues.

Q4. Is our approach to cost assessment appropriate? Are there alternative approaches we should be considering?

Three tables answered this question.

The first table suggested that:

- Costs and decisions about funding are being treated as separate issues.
- Planning assumptions will consider ‘all connections’ to DNO networks.
- Can’t use benchmarking in decisions regarding asset replacement costs.
- One option is to use external benchmarking (from other industries). This might not give the right answers however there is scope for understanding or knowledge gathering.
- Meaningful information should not be highly disaggregated.

The second table summarised that:

- Need to be clear on capex and opex allocation.
- Need to take into account the reality of network conditions.
- Over/under spend on opex/capex signals bottom-up engineering issues. RRP process enables focus on these issues.

The third table suggested that:

- Benchmarking is useful but we need to be careful on how it is used and ensure transparency. There are some concerns regarding cherry picking but as long as the approach is high level and transparent this should be avoided.

- Indirect costs should be included in benchmarking.

- Building blocks will be used to build up forecasts but there is also a need to look at historic forecasts.

- DNOs need to take ownership of their business plans and to take responsibility for the delivery of outputs.

- Need for appropriate indexation especially against a background of rising prices.

Q5. Have we captured all the key issues for “networks”?

Three tables answered this question.

The first table summarised that the key issues are to:

- Reward performance across range of services
    - Overall and guaranteed standards
    - Extend reward mechanisms

- Regulating focus on driving costs down
    - Too many issues being consulted on
    - Need to focus on customers and costs

- Market changes
    - Competition in connections (IDNOs) – no losses incentive
    - Basis of regulating IDNOs may need reviewing in context of environmental approach where it may not be appropriate to rely on incentives

The second table suggested that:

- The key issues at a high level have been captured but negotiation will be needed on the detail going forward.

The third table summarised that:

- The document had broadly captured the key issues.

- There is a need to consider environmental issues and the impact on networks of government policy, connection and use of renewable and issues around planning.

- The group identified some key questions as:

    - What is the impact on networks of the environmental agenda?
    - How do networks deal with changing needs and incentives?
    - Is the feedback loop for issues arising from stakeholder consultation clear?

Q6. What is the best way for DNOs to gain stakeholder input to their forecast business plans and how should Ofgem facilitate/incentivise this?

One table answered this question and suggested that:

- Each DNO needs to consult its regional stakeholders individually.

- Stakeholder input can be gained by keeping the demands on them in moderation and by remaining consistent in our approach.

- Ofgem should share best practice across all DNOs and help to co-ordinate key and common stakeholders.

4. Afternoon Sessions - Financial Issues

Presentations by stakeholders

1. Key issues for DPCR5 – Ofgem – Kieran Donoghue

2. RAV premia and implications – CE Electric – Ken Linge

Question and Answer

Asset life

One attendee asked if our concern over the sustainability of the 20 year depreciation profile is based on intuition or modelling, because he had carried out modelling that suggested there was no cause for concern

Kieran Donoghue (Ofgem) responded that this is based at the current time on intuition and that we are looking to follow this up with modelling.

Business model

One stakeholder asked Ken Linge (CE Electric) to explain why he had compared the DNOs with Northern Rock.

Ken Linge replied by indicating that Northern Rock was thought to have an ideal business model with a mixture of long and short term financial goals. Unfortunately in the long run this did not work for Northern Rock.

Roundtable discussions and feedback

Each table was then assigned questions to discuss. Following the discussions, each table was asked to deliver a five minute summary of their views. Outlined below is a brief summary of the views presented in response to each question.

Q1. Are there relevant insights to be gained from recent utility transactions at a large premium to RAV?

Three tables answered this question.

The first table suggested that:

- There are different ways to measure a premium. Aside from transaction premium there is trading premium for listed companies. This has recently been in the order of 10-15%, but could be interpreted as a positive factor – a sign of confidence in the regulatory regime and the management of the companies.

- The group agreed that we do want investment in these companies. They suggested that there is a supply/demand issue, in that there are more people who want to invest than opportunities to do so.

- Buyers may pay a premium in order to take control. The buyer's decision will be based on a number of assumptions, which may be wrong.

The second table suggested that:

- There is a need to understand what drove the premium, and the group suggested that it was Ofgem's role to do so.

- For example, the premium could be due to the cost of capital being too high. We need to consider whether DNOs' general underspend on capex and overspend on opex is relevant.

- The premium could be due to "winner's curse".

- It is difficult to establish whether this transaction is indicative of a trend or is a one off.

- It could be useful to look at international comparisons if there is limited data available nationally on similar transactions.

- This information is useful as supplementary evidence to understanding financial issues.

The third table suggested that:

- Need to look at the specifics of each transaction as each is different and it is not appropriate to generalise.

- The dilemma for Ofgem is when such transactions load debt onto the DNO, and so our concerns should be consideration of the implication of highly geared structures.

- The group did not expect there would be many further high premium transactions in the present climate due to issues such as the credit crunch.

- Need to consider the impact of the stability of UK regulation on influencing RAV premium.

Q2.Should we introduce an adjustment mechanism for material changes in the tax regime?

Three tables answered this question.

The first table summarised that:

- Material change means significant change. It may be relevant to undertake comparisons with Ofwat.

- The group suggested that if the change is significant, such as a material change in tax law, then it would be appropriate to protect the DNOs from significant risk

- Adjustment mechanisms should be symmetrical, in order to maintain investor confidence.

The second table suggested that:

- There were three options for this:

  - introduce a re-opener for mid-stream change,
  - change at DPCR5 to allow claw-back, or
  - do nothing.

- It was suggested that an adjustment mechanism would need a defined materiality threshold.

- The group suggested that incentive regulation should look to incentivise DNOs where they have a greater level of control. They asked whether DNOs have control over tax issues but suggested that an adjustment mechanism would reduce incentives on DNOs to manage their tax exposure.

The third table suggested that:

- Adjustments were appropriate but that these should be symmetrical.
- Materiality can be assessed in terms of:
  - legislative change,
  - tax changes, and
  - external influence.
- Need to look holistically at all changes to tax.
- Management are limited in what they can do when the tax regime changes, but this was not a reason to remove the incentive to manage their tax costs.
- There were practical issues.

Q3. Should we introduce debt triggers or index the cost of debt allowance to market movements?

Two tables answered this question.

The first table suggested that:

- The key issue is the transfer of risk and we need to consider where this is most appropriately placed, on DNOs, suppliers or customers. Such measures would de-risk the DNOs but it would seem most sensible for the risk to sit with the DNOs where it is best managed.
- Re-setting the cost of debt every 5 years (as in current price controls) was frequent enough to respond to changes in debt market conditions.

The second table summarised that:

- There was a perception that the current method is overly generous, which was prompting Ofgem to explore these ideas as a way of reducing the WACC.
- The group asked how we could define the index. They suggested that there was a need to consider periodicity, benchmarking and elasticity.
- The incentive effects would be to promote short term borrowing by DNOs.
- The group said that the benefit for customers was uncertain in return for passing risk onto them.
- The group suggested that index linked debt could be used for new debt only.
- The group suggested that making such changes could increase regulatory uncertainty and discourage investment.

Q4. What are the alternatives for calculating RAV?

One table answered this question:

- Rules to define the split between capex and opex have an impact on decision-making and thus have affected the allocation of work. This may not be economically efficient.

- We need to consider what RAV is used for and whether it is still meaningful.

- The value of RAV is to allow companies to finance investment and thus smooth costs to consumers.

- The group asked why RAV is so different between DNOs. Use of system charges need to be rational based on how the DNOs are run, and there is also a need to consider issues of depreciation and the workforce cliff-face.

Q5. Should we consider financeability adjustments if we are satisfied the cost of capital is appropriate?

Three tables answered this question.

The first table summarised that:

- In theory the rationale behind financeabilty adjustments is doubtful if the cost of capital has been correctly set.

- However, such changes would be quite different to established practice and the investment community would need time to take this into account. The group considered that this was a radical issue and so it would be more appropriate to look at it as part of the RPI at 20 review than for DPCR5.

- DPCR5 should be used to look at the reasons for investment and to undertake modelling work to understand cashflows. Ofgem need to understand if investors would accept zero dividends for a period if the overall expected return was acceptable, for example.

The second table suggested that:

- In theory such adjustment should not be required if the cost of capital is high enough.

- However, in practice it is not this simple. There is a need to consider the impacts of capex profile, depreciation and the workforce cliff face

- The group suggested that agreed financeability ratios and clear parameters are important. They questioned how Ofgem could know if the cost of capital is appropriate until it had examined financeability ratios.

The third table suggested that:

- We should consider:

    - Actual vs. notional gearing levels
    - Accelerated depreciation
    - Accounting vs. technical asset life
    - Costs vs. revenue profiling

- The group said that it can be appropriate to use adjustments in some cases and that this had worked well in the past.

Q6. Have our pension principles worked well? Are they still appropriate in a climate of increasing contribution rates and required payments to close deficits?

Three tables answered this question.

The first table summarised that:

- The current principles, which are close to pass-through, are good and that arrangements have worked well.
- There are three areas of tension:
  - The group suggested that Ofgem were looking to keep prices down, while the pensions regulator is looking to keep investment high.
  - Some DNO pension schemes have both regulated and unregulated employees and there is a need to ensure that pension arrangements are consistent, thus providing appropriate incentives to keep pension costs down where possible, even if the regulated company can be confident of recovering its costs in full.
  - The trustees' independence has been strengthened by legislation, so there may be tension between them and the company's management.
- Ofgem's role should be to observe and to only intervene if issues arise.

The second table suggested that:

- Current rates are the result of historic policy decisions on schemes that are now closed to new entrants. DNOs have little control on costs and so pass-through of costs is appropriate.
- In terms of stewardship, trustees are fully independent from DNOs and the group asked if it was appropriate to penalise DNOs for decisions made by independent trustees.

The third table summarised that:

- The group asked how we could define what we mean by "worked well". This could mean that no adjustments have been made.
- There are good governance arrangements in place through the FSA and independent trustees. They suggested that it would be difficult to decide that costs would not be fully funded, although they recognised that the costs involved are very significant.
- They suggested that existing arrangements have worked well and allowed efficiencies to be developed in other areas. We should take a holistic view of the overall employment package.