



National Grid

Regulation

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Dear Cemil

DEVELOPING NETWORK MONOPOLY PRICE CONTROLS - INITIAL CONSULTATION

Ofgem's document sets out a framework for reviewing the operation of the (main) price controls for all the energy network companies, including Transco, National Grid and the DNOs. The aims of the project are stated to be to:

- improve the framework of price controls applying to all network monopoly companies and, where appropriate, increase consistency in the approach that is taken on setting price controls; and
- lay the foundations for the next distribution price control review in 2003/04 including identifying the objectives, key issues and principles that will be used in setting the price control that will be implemented from April 2005.

To this end, Ofgem has set up a number of joint Ofgem/DNO working groups to address those issues specifically associated with the next distribution price control review but has not, as yet, set up a parallel process to address the more generic issues. It is essential that Ofgem sets up a similar process to address these latter questions. This is not least because:

- Several of the issues facing the non-DNOs (i.e. National Grid and Transco, as well as the Scottish transmission businesses) are different from those facing DNOs, not least because of:
 - differential scope for benchmarking (apparent scope with the DNOs, less apparent scope for transmission), with the implications this has for available techniques for estimating efficient inputs and outputs;
 - the existence, for National Grid and Transco, of mechanisms outside the main price controls (notably System Operator price controls) for dealing with investment/output incentivisation and, to a greater extent for Transco than for National Grid as things currently stand, for "dealing with uncertainty" about required capital expenditure;
 - different charging methodologies (e.g. with respect to connections) which also have implications for, inter alia, how uncertainty can be dealt with during a price control period; and
 - the different capex histories of National Grid and Transco, notably the fact that both of their networks were constructed over shorter periods of time than the DNOs,



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implying, inter alia, greater problems in applying techniques like total cost modelling which tend to be more useful when dealing with steady state networks.

- The existing process involves the DNOs but does not involve either National Grid or Transco.

We therefore hope that Ofgem will initiate a new workstream on generic price control issues. We would be keen to participate in this.

Against the above background, this response focuses on Chapters 2 and 3 of Ofgem's paper (which deal with generic price control issues, as against Chapter 4 which deals with DNO-specific issues) and under the following headings from Ofgem's paper:

- timetable and process for price reviews;
- approach to objectives, principles, key issues, outputs and incentive framework;
- collecting information from companies;
- consistency between different network price controls; and
- incentives for efficiency.

Timetable and process for price reviews (including publication of information during price reviews)

In our view, much of the standard price review consultation process (Issues, Initial Thoughts, Draft Proposals, Final Proposals) works well. However, two areas where we see particular scope for improvement are:

- the level of detail about underlying assumptions included in Draft and Final Proposals; and
- the availability of draft licence amendments at the time of Final Proposals.

Detail of assumptions underlying Draft and Final Proposals

When Ofgem publishes its proposals, little quantitative information on its assumptions is revealed below the level of the high level inputs ('opex' and 'capex') into the revenue calculation. This is unsatisfactory for two main reasons:

- First, it reduces the scope for dialogue between companies and Ofgem as part of setting a price control, as well as reducing the scope for constructive intervention by third parties. Ofgem has sometimes argued that the reason for presenting proposals as a 'package', without showing the detail on which the proposals are based, is because otherwise companies would 'cherry pick' the detailed assumptions. In other words, companies will focus on those areas where Ofgem has erred on the side of assuming too low a level of costs and will ignore areas where Ofgem may have been more generous.

This is a somewhat defeatist argument. It assumes that Ofgem will never attain reasonable understanding of companies' costs and is arguably inconsistent with Ofgem's general pro-competitive ideology in which cherry picking is a force for good.

- Second, this lack of transparency is completely inconsistent with Ofgem's proposed Regulatory Accounting Guidelines for NGC and the DNOs. Ofgem has stated that one of the main purposes of the revamped regulatory accounts is to allow Ofgem (and others) to monitor the performance of the energy networks against the assumptions made at the previous price review. To this end, the network companies will be required to report information on actual performance, including cost information, in some detail.

However, Ofgem's price control proposals have never included Ofgem's assumptions at this level of detail. In fact, it has never been clear whether even Ofgem's private calculations built up proposals from this level of detail. As a result, there is no scope for meaningful comparisons between performance and assumptions at the level which the Regulatory Accounting Guidelines require.

In the short term, and prior to the next round of price reviews, this inconsistency can be remedied only by either reducing the amount of detail required for regulatory accounts and/or by explicitly recognising that detailed, line by line, comparisons between performance and assumptions will have little meaning. In the longer term, Ofgem could remedy this situation at the next price reviews by publishing its assumptions at the level of detail required by its own Regulatory Accounting Guidelines.

Timing of publication of draft licence amendments

Ofgem's practice at many price reviews has been to publish Final Proposals somewhat in advance of discussion or publication of the licence amendments which will implement these proposals. This is unsatisfactory as it means that companies can be required to accept proposals without knowing exactly what those proposals mean. It has not been unknown for material issues of contention to arise at the later licence drafting stage. Any problems in this area would be at least mitigated by Ofgem publishing draft licence amendments as part of its Final Proposals at a price review and it is welcome that Ofgem states that "The intention is that by the time final proposals are published Ofgem will be in a position to make available to companies a detailed draft of the changes to the licence that will be required to implement the new price control".

Approach to objectives, principles, key issues, outputs and incentive framework

Ofgem identifies a number of 'standing' factors which will influence the setting of price controls (e.g. statutory obligations on both network companies and on Ofgem itself) and a number of interests which will need to be taken into account. However, the overriding issue from a company point of view is that of **consistency** between what companies will be required to do and the revenues which will finance those obligations, whatever those obligations are.

Potential inconsistency between obligations and revenues may arise from a variety of sources. Ofgem itself points out the issue of uncertainty, not least with respect to the way that distribution systems will need to develop in future.

However, potential inconsistency also arises from Ofgem's own objectives. A central feature of Ofgem's work on the development of price controls, whether the 'main' controls or the System Operator price controls for National Grid and Transco, is that companies should be more powerfully incentivised to achieve various objectives, including the objective of investing efficiently. In general, these more powerful incentives (both those already implemented, such as IIP, as well as those still under consideration) will involve exposing companies to greater risk, as well as the potential for greater reward.

In fact, if Ofgem's apparent vision in some of these areas was fully implemented, the whole risk-reward profile of network companies would be transformed. It is not currently clear that Ofgem's consideration of network companies' costs of capital is fully recognising the progressive impact of continuing change to the framework of incentives. This position is not helped by one part of Ofgem being responsible for 'main' price controls and another part being responsible for System Operator controls.

Collecting information from companies

Ofgem has previously stated its intention to reduce the informational burden of price reviews. To this end, it has initiated a variety of processes for annual provision of information, including revamped regulatory accounts.

We agree with the principle of reducing the informational burden of price reviews. However, we have doubts whether the proposals for regulatory accounts, in particular, will efficiently address the issue. This is, in part, because one of the main points of the accounts will be to show comparability of performance of the network companies through time. For this purpose, there will need to be a high degree of consistency, through time, in the basis on which performance is analysed in the accounts.

However, the experience of price reviews is that the information required by regulators changes continuously and, over the five years between price reviews, changes substantially. There is, therefore, a substantial risk that either:

- a) the analysis required by the accounts will not change much from year to year, in which case it is unlikely that the information will provide answers to changing regulatory questions; or
- b) the analysis required in the accounts will continuously change, thus requiring substantial pro forma reformulation to provide any comparability through time.

It is a particularly moot point whether the effort expended to create auditability and comparability between different companies is worthwhile in the case of National Grid and Transco when Ofgem has previously accepted that neither of these companies have obviously usable comparators.

It is at least arguable that, particularly in the case of National Grid and Transco that Ofgem's requirement for price control information would be met more efficiently through:

- a) the periodic review process itself; and
- b) an annual information filing which would evolve with Ofgem's changing needs but which would not require the formality of audited accounts and would not require pro-forma retrospection.

Consistency between the different network price controls

Consistency **between** price controls which apply to different companies should not be an overriding objective, not least for the reasons given above about the differences between some of the price control issues facing the DNOs, on the one hand, and National Grid and Transco on the other. In general, and as stated above, what is more important is consistency of a price control with the risks and obligations faced by the company to which the control applies.

However, having said this, it would be desirable, not least from the angle of minimising regulatory risk, if there is a consistent philosophy underpinning the different price controls. In addition, there are no obvious public interest reasons for some of the current inconsistencies between the different controls, e.g. different mechanism for capitalising expenditure into RAV and different durations for retaining the benefits of efficiency savings. Both of these latter issues are discussed below under 'Incentives for efficiency'.

In addition, there is one particular area where we do see a risk of inconsistency between National Grid's main price control and the DNO price controls. This is in the area of DNO investment at Grid Supply Points (GSPs). We currently see a fairly sharply rising future need for replacement of our GSP assets. From a joint National Grid/DNO point of view, it would be more efficient to replace simultaneously those assets at a GSP belonging to both National Grid and the DNO. However, a number of price control pressures may militate against this solution, including DNO worries that National Grid connection charges will not be passed through in future price controls. If a jointly optimal solution is to be found to replacing transmission and distribution GSP assets, there may be a case for providing reassurance on this and for, for example, earmarking part of any future assumed DNO capex for GSP asset replacement.

Incentives for efficiency

Ofgem's paper discusses four aspects of incentives for efficiency:

- strength and periodicity of incentives;
- distortion of incentives between capital and operating expenditure;
- assessing efficiency; and
- incentives to invest and quality and security of supply.

Strength and periodicity of incentives

Ofgem's previous method for setting price controls for National Grid and Transco has been to assume that any out-performance against assumptions made at the previous price review should be immediately incorporated into any forward-looking view as to what an efficient level of costs should be. This approach clearly means that the incentive to improve operating or capital efficiency reduces through a price control period.

However, despite this, the question of whether the current method of setting price controls gives an 'adequate' incentive to reduce costs depends on what is required to improve efficiency. If a network company can improve efficiency without any front-end investment, then it may still have an adequate incentive to improve efficiency under the current regime, even towards the end of a price control period.

Instead, the reason why the current 'periodicity' effect is an important deterrent to efficiency improvement is that such improvement now, and more than in the immediate aftermath of privatisation, requires significant investment – whether that investment be in IT, property, training, more generalised restructuring (including mergers) or whatever. There is, therefore, now a strong customer interest in both giving stronger incentives to improve efficiency and in making those incentives continuous.

Ofgem points out the direction taken by Ofwat and, more recently, by Ofreg on this issue. In this approach, a rolling adjustment mechanism is used whereby companies retain the benefit of out-performance against price control assumptions for a fixed period of time, regardless of when the savings are achieved.

We support this approach. However, the approach is unlikely to work effectively unless combined with other elements of Ofgem's approach to price reviews. This is because, with this approach, when a regulator estimates a company's operating costs during the next price control period, the calculation effectively has two elements, i.e.:

- a) the scope for future efficiency improvement; and
- b) retention of the benefit from out-performance in the previous period.

Overcoming the periodicity problem under the current RPI-X regime through the approach taken by Ofwat and Ofreg presumes that out-performance in one price control period (i.e. the amount under b) will not increase the estimate of a. To the extent that the regulator simply gives with one hand (through b) but takes away with the other (through a), there will have been no strengthening of incentives to improve efficiency.

Although benchmarking can, in principle, mitigate this problem (through reducing the feedback from one company's performance in one price control period to its cost 'target' for the next period), neither NGC nor Transco have obvious comparators. This increases the desirability of Ofgem demonstrating the linkage between bottom-up efficiency reviews and its assumption about the scope for future cost reductions.

Distortion of incentives between capital and operating expenditure

In its first review of distribution controls, Offer adopted an approach to capitalisation and depreciation which had three main elements:

- a division of what accountants would normally classify as 'capital expenditure' into 'network capex' and 'non-operational capex';
- the capitalisation of all network capex into RAV with a standard asset life of 40 years; and
- no capitalisation of non-operational capex.

This approach achieved two desirable effects from Offer's point of view. Specifically:

- it substantially reduced a network company's ability to influence the regulatory categorisation of expenditure (into opex or capex and, therefore, whether or not the spend went into RAV) through its accounting policies; and
- it made modelling of the primary price review calculation very simple.

However, the approach also constitutes a major distortion of incentives. In particular:

- it encourages network capex relative to other forms of expenditure; and
- it discourages investment in IT, already discouraged by the above noted periodicity issue, at a time when IT will be at the heart of most future improvements in operating efficiency.

What is required (and what was discussed at some length in Transco's last price review), is a reclassification of expenditure into a limited number of categories which would eliminate the 'all or nothing' choice between expensing and 40 year RAV assets. One precedent is the current National Grid System Operator price control in which IT assets have a 7 year RAV life, but it is for consideration whether other 'non-operational' capex should also go into the RAV, albeit for less than 40 years, and whether there should (as was discussed in the price control proposals for Transco) be further sub-division of the asset lives of network assets themselves.

Ofgem raises the issue of monitoring capital expenditure to protect against excess capitalisation into RAV, especially if non-network expenditure is allowed into RAV. However:

- recent price reviews suggest that policing of accounting practice in this area is not an impossible task; and
- the task would probably be made significantly easier if, at the margin, the choice was between classifying an asset as, say, a 7 year asset or a 10 year asset, rather than the current choice in electricity between non-capitalisation and a 40 year asset. This is because, first, the incentive to misclassify assets would be less and, second, the regulatory classification would be closer to the classification for financial accounting purposes. To a large extent, potential monitoring problems stem from the fact that Ofgem's current regulatory demarcation between opex and capex is so divorced from normal financial accounting practice.

Assessing efficiency

Ofgem raises a number of issues under this heading, including:

- the use of benchmarking;
- the use of a 'total cost approach', rather than separate assessment of capex and opex requirements;
- impact of mergers.

On the **use of benchmarking**, we think that, even for DNOs, the difficulty of adjusting for differences in operating environment between companies means that any **mechanical** use of benchmarking to judge aggregate efficiency will be unwise. The problem is even greater for companies like National Grid because of the lack of obvious comparators within the UK and well known difficulties (rehearsed at previous price reviews) with international comparisons.

As regards the use of a **total cost** approach to assessing efficiency, we will be interested to see exactly what is being proposed. If the proposal is to aggregate capex and opex, then this will need substantial adjustment for different requirements for (replacement and enhancement) capex – and it is hard to see how such an approach would sit with either current uncertainty about future capex requirements or with emphatically non-steady state networks such as those of National Grid and Transco. If, on the other hand, the proposal is to aggregate opex and capital consumption, then this begs the question of whether yet another measure of capital stock will be required, in addition to HCA (the basis for statutory and regulatory accounts) and RAV, currently the basis for revenue determination.

On the question of the **impact of mergers**, we have noted Ofgem's recent document on mergers between DNOs and its conclusion that merger savings should be treated like any other savings. We agree with this conclusion and, given this, our view is that the main issues here are the ones covered above under periodicity. Mergers, like that between National Grid and Transco, can be expected to produce significant cost savings, to the long term benefit of customers – but these savings will require significant front-end costs (a fact recognised by Ofgem's past practice of allowing companies to keep merger savings for five years from the date of completion of the merger).

As a result, efficient mergers will be discouraged if current price control practice is combined with the conclusion of the distribution mergers document to imply that companies will only be able to keep any savings up to the end of the current price control period. The proposal to

allow out-performance against price review cost assumptions to be retained by companies for five years should apply to merger savings, as to any other savings.

Incentives to invest and quality and security of supply

As Ofgem says, all the network companies are currently engaged in Ofgem's asset risk management survey. In addition, NGC is currently in discussions with Ofgem about how its System Operator price control can be made 'deeper' to further sharpen the incentives to invest efficiently. Pending the outcome of those discussions, we would see the main **new** incentives on our investment programme coming through this channel, rather than through the main price control.

Overall conclusions

As noted at the beginning of this response, many of the issues which Ofgem is examining as part of this review have different resonance for DNOs, on the one hand, and National Grid and Transco on the other. In particular, differences for the latter revolve around the existence and development of System Operator price controls and the lack of obvious comparators for overall efficiency assessment.

However, as suggested above, the framework for National Grid's 'main' Transmission Owner price control could be improved by:

- a rolling mechanism for National Grid to retain benefits of out-performance against price review cost assumptions for five years from the date of out-performance;
- clear (and published) derivation of price review cost assumptions from a bottom-up analysis of National Grid's operating costs (which would help to underpin the rolling mechanism, as well as providing the inputs required by Ofgem's proposed Regulatory Accounting Guidelines);
- publication of draft licence amendments alongside final price review proposals; and
- a closer alignment between regulatory depreciation and accounting depreciation, including the capitalisation, and depreciation over an appropriate period, of non-operational capex.

As a final point, Ofgem's document makes it clear that one of the key points of difference between the network companies is whether or not they have a System Operator price control. However, different parts of Ofgem are responsible for System Operator price controls and for 'main' price controls. While the System Operator controls were 'shallow' controls for incentivising the 'external' costs of day-to-day system operations, this did not matter greatly. However, with Ofgem's push to Deep System Operator controls, this is emphatically no longer the case, with consideration of opex and capex spread between the two controls. Continued lack of integration between the consideration of main price controls and System Operator controls is unlikely, in the longer term, to produce an internally consistent overall outcome.

Yours sincerely

Tim Tutton
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