

≡ Scottish and Southern Energy plc

Cemil Altin
Head of Price Control Development
Ofgem
9 Millbank
London
SW1P 3GE

Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Telephone: 01738 456400

Facsimile: 01738 456415

30 September 2002

Dear Cemil

DEVELOPING NETWORK MONOPOLY PRICE CONTROLS INITIAL CONSULTATION

We welcome this consultation paper and its objectives to increase the consistency of approach taken in setting price controls for all network monopolies. We also appreciate the earlier start on the distribution price control review, which will enable full debate of the issues for this price control review and spread the workload over limited resources. We also value the opportunity we have been given to contribute to the initial discussions with Ofgem and we recognise that the Initial Consultation reflects many of the points which we and the other DNOs have made.

Our key comments on the detailed points raised in the paper are set out below.

Workstream 1: Developing the price control framework for all monopoly network companies.

- the incentives provided to companies to operate efficiently. The opportunities for further efficiency improvements, particularly in operating costs (opex), are small in relation to the efficiencies made since privatisation. This is especially so for the 'frontier' companies such as Southern Electric Power Distribution plc (SEPD) and Scottish Hydro-Electric Power Distribution Ltd (SHEPD). Against this background, it is vital that the price control provides appropriate incentives to continue to strive for opex efficiencies.

We still believe that the 'frontier' methodology, adopted at DPR3 to incentivise efficiency, weakened incentives when compared with the 'average cost' or yardstick methodology which had previously been used in DPR1/2. We also believe that 'rolling' opex is a weaker incentive than 'average costs', although it can have stronger incentive properties than the 'frontier' methodology.

Another key issue in assessing efficiency and incentives will be the treatment of merger savings. Ofgem's Policy Statement is not clear how this would be dealt with in a price control review, particularly consistency with the methodology used in DPR3 and the different approach used for subsequent mergers. It is important that mergers are recognised as an important means of improving efficiency, and rewarded accordingly;

- the incentives provided to companies to invest in their networks. There has been a need since the last price control review (DPR3) for clarity on how capital expenditure (capex) will be treated in the next price control review (DPR4). Associated with this is the danger of the trade-off between short term cost savings and the longer term security of the network.

DPR3 significantly moved incentives away from spending capex and towards spending opex. This included allowing companies not on the opex ‘frontier’ time to catch up with the frontier companies (and then only 75% of the way), and the ‘within range adjustments’ which were applied for growing the RAV or exceeding the capital efficiency benchmark. In particular, the latter were arbitrary and had no robust basis. There was no explanation of why growing the RAV was undesirable, and there was no real assessment of the efficiency of capex spend on quality improvements.

We believe that this has acted as a significant disincentive on companies to invest, particularly for the longer term. It is our view that certainty of inclusion in the RAV still represents the strongest incentive to invest (provided of course that the rate of return allowed is attractive).

- balancing incentives for efficiency with improvements in quality of service. We recognise that quality of service targets are important to avoid reliability being sacrificed for efficiency. However, there is very little knowledge in the industry about what improvements customers are prepared to pay for.

We are pleased therefore that Ofgem intends to carry out research in the area of customers’ ‘willingness to pay’ and to identify additional output measures. Where additional outputs are identified then the companies should be incentivised appropriately. This applies equally where targets need adjusting, and companies should clearly be allowed to recover the efficient costs of achieving tougher targets.

In any event it will be vital to ensure that any future targets and standards are consistent with the capex and opex allowed;

- dealing with uncertainty. There is a considerable need to develop the understanding of the growing number of risks faced by the companies, for example distributed generation, lane rentals, supplier failure, the energy White Paper etc., and how to allocate them between those which companies could be incentivised to bear and those which should be borne or passed-through [ultimately] to consumers.

A related issue is regulatory change to the price control “bargain” mid-price control. This includes standards of performance (e.g. the Multiple Interruptions Guaranteed Standard (MIGS)), but also unforeseen development costs arising from regulatory changes to industry agreements (e.g. REMA). We would therefore expect the next price control to set out much more clearly exactly which anticipated changes are included in the allowed revenue calculation.

- Tax changes. The tax treatment of capitalised non-load refurbishment expenditure changes with effect from 1 April 2005. This is as a consequence of changes in the interpretation of tax law introduced by the Inland Revenue in Tax Bulletin 53. The Bulletin states that expenditure currently treated as revenue for tax purposes (i.e. 100% tax deduction in the year expenditure was incurred) will be treated as qualifying for relief in line with the accounting depreciation rates for accounting periods starting after 30 June 1999. The first year of application would be the year ended 31 March 2001. However the Industry has reached agreement with the Inland Revenue that for Distribution non-load refurbishment expenditure the changes will apply from 1 April 2005 to coincide with the next Distribution Price Review.

It is nonetheless clear that this change will result in substantial additional costs to distribution businesses, which will run into tens of millions of pounds. It is therefore imperative that the above additional costs are reflected in the price review or an appropriate change or exemption from the tax regime is applied from 1 April 2005 to reverse the proposed treatment.

- the financial model. The objective ‘to seek to ensure that the DNOs can finance their licensed activities, commensurate with an efficient level of expenditure’, needs further consideration. In order to be fair, the price control must be based on the ‘building blocks’ of opex, capex (recovered through an allowance for depreciation) and return on RAV (including taxation). It would not be acceptable for the financial model (or more specifically a pre-set range of ‘acceptable’ rates of return) to drive the outcome of the review. This would also damage incentives to, for example, invest in the network.

To this end we welcome Ofgem’s intention to share the financial model with us, and expect that the companies will be involved in the development of the model. We would suggest that a further working group be established to develop the model;

- use of consultants and collection of data. We note that Ofgem is reviewing its use of consultants and the collection of data from the companies. The use of consultants to assess companies’ efficiency and to test companies’ capex plans in a price control review can be subjective. We consider that a better understanding of the issues can be arrived at through Ofgem working with the companies.

The introduction of the Regulatory Accounting Guidelines (RAGs), IIP, RIGs and the associated audits, and the Asset Risk Management (ARM) survey should mean that Ofgem can significantly reduce their use of consultants. Indeed, the RAGs were justified by Ofgem on the basis that the amount of information requested at the price control review would be substantially reduced. We would therefore expect to see this fully reflected in the requests for information. This applies particularly to the amount of data which is asked for in the Business Plan Questionnaire.

Workstream 2: Identifying the objectives, process, key issues and principles ahead of the next distribution price control review.

The points made above clearly apply specifically to the DNOs as they do to network monopolies in general. Other key issues specific to the DNOs are set out below.

- the impact distributed generation (DG) will have on distribution networks. We support the work being undertaken by Ofgem to consider the regulatory issues raised by DG. We agree that it is important that there are no barriers to the take up of DG. However, it is also important that DNOs are not left with stranded assets or increased counter party risks.

As part of this, the working group on distributed generation will also need to consider the interaction with the distribution price control. The aim should be for a simple solution initially, not to try to solve all the problems at the outset, and one that incentivises DNOs to connect and utilise DG. This might be, for example, a differential cost of capital combined with a 'p/kwh connected' allowance in the price control. This would continue to incentivise DNOs where reinforcement has been avoided (and therefore no costs have gone into the RAV);

- competition in metering and connection. The suggested objectives for DNOs include to 'ensure that competition is promoted in the provision of supply connection and metering services'. The DNOs obligation is to 'facilitate' not to 'promote'. This has an entirely different connotation;
- split of the metering price control. There are significant issues associated with the proposed split of the metering price control, including the recovery of sunk costs/stranded assets, and the valuation of the RAV. We do not believe it is necessary to split the price control, and therefore these problems can be avoided. The simple solution is for, with effect from (say) 1 April 2005, all new meters installed to be outside the price control and treated as an excluded service, leaving all existing meters within the price control. The existing price control condition, whereby allowed revenue reduces by avoidable costs on loss of market share, could be continued post-2005;
- the review of IIP. In particular, we do not believe that it should necessarily be assumed that targets need to be tightened, although if targets are tightened that will clearly have implications for companies' investment programmes. There is also a debate to be had about the amount of allowed revenue which will be exposed to IIP, and the impact of DG on IIP;
- the Multiple Interruptions Guaranteed Standard. We firmly believe that Ofgem should reconsider this standard from first principles as part of the price control review. In particular, it will be necessary to take explicit account of the capex required to achieve full compliance with any MIGS post-2005. It will also be necessary to set out how compensation and administration costs will be fully recovered.

Ofgem's proposed approach to undertaking price control reviews.

Transparency. We support Ofgem's proposals to introduce greater transparency into the process, particularly the use of workshops, which enables a wider understanding of not only Ofgem's views but also individual company views.

Reviewing companies' performance against the existing price control. We fail to see the relevance of this. It is suggested that there is a need to inform the 'frontier'. However, we do not believe that the 'frontier' methodology has the strongest incentive properties, particularly when the scope for cost savings is small.

We also do not understand why past performance will be any guide to future trends.

In addition, in the ongoing monitoring of revenue collected and outputs delivered, Ofgem must avoid 'micro-management' of companies. The 'regulatory contract' is for the price control period, not on a year by year basis. It is for the companies how they deliver the 'contract'.

Establishing the objectives of, and key issues for, the price control review. We support arriving at the key issues at an early stage. The key decisions required are about how companies should behave, and incentives flow from this. Also, only then can the information requirements be decided, and a 'scatter gun' approach avoided.

Review of existing network monopoly price controls.

Consistency between networks. We recognise that there is already a large amount of consistency in the price controls between networks, and work is underway to improve consistency.

In particular, we look forward to seeing the output from the joint work between regulators on the cost of capital. The allowed rate of return (represented by the cost of capital) is a crucial incentive to invest.

There are many risks faced by companies in addition to providing a base level of service. There is a need for work to be done on developing mechanisms for managing these risks. One option is for differential allowed rates of return to reflect the differing risks of different types of investment. For example, Ofgem have allowed an extra 1% for investment which avoids network investment, and this may merit further consideration.

Distribution losses. Any work on distribution losses must be supported by a robust cost/benefit analysis. Incentives to reduce losses will increase companies' costs and must be fully reflected in the price control.

Rolling capex. This is predominantly about strengthening the incentive to spend capex efficiently, with no risk of 'clawback'.

Ofgem's commitment to a 'rolling capex' methodology is 'subject to meeting obligations on quality and security'. This needs clarification. Provided companies

meet their reliability targets, and investment is efficient on a unit cost basis, then their capex should be allowed into the RAV. In particular, companies cannot be exposed to a double penalty i.e. IIP penalties, and the investment not being allowed in RAV. IIP would hardly be an incentive scheme if investment were not allowed in the RAV.

Opex. As noted above, we believe that the incentives to manage opex efficiently will be vital in the next price control. The present mechanism could be improved, for example one option is to increase the duration of the price control, which would also correct any perception of periodicity.

Another mechanism which has been suggested is ‘rolling opex’. In a number of ways this provides stronger incentives than the ‘frontier’ methodology, but it is still weaker than an average costs/yardstick approach. There may also be difficulties if opex is not falling or stable, as is looking the case in the next price control period e.g. lane rentals.

Distortion of incentives between capex and opex. We firmly believe that the extent of any capex/opex trade-off is overstated and in practice there exists limited opportunities to reduce opex by increasing capex.

As a consequence, the perceived distortion of incentives is not a substantial issue.

Total cost modelling. It has been suggested that ‘total cost modelling’ (TCM) may be used to assess efficiency. We are concerned that this should not be used to set allowed revenue or to ‘adjust’ allowed revenue. Calculating allowed revenue from the building blocks of opex, capex and financing costs, still represents to us the only fair and robust way of setting companies’ allowed revenue.

Opex and capex efficiency must be assessed separately. It would be extremely difficult to come up with a robust definition of ‘total costs’ and methodology for ‘total cost modelling’, without undermining the incentives to invest

Differential treatment of different categories of capex.

To date non-operational capex has been treated in the price control review as expensed (opex). This means in practice that investment, for example in IT systems needed to achieve operational efficiencies, currently has to be recovered in the price control period. We support moving to a capex approach, allowing non-operational investment to earn a return over its useful life, through the RAV.

The next distribution price control review.

Revenue drivers. There are already examples of revenue drivers which have been developed to deal with uncertainty. For example, the volume driver in the price control formula allows for changes in the forecast level of demand, and Transco’s supplementary capex incentive allows for an uncertain level of replacement spend.

There are a number of mechanisms for dealing with uncertainty which need to be explored, other than through the cost of capital, to deal explicitly with as much risk as

possible, the remainder being covered by the cost of capital. We recognise that Ofgem's working group is working on these. These range from pass-through of actual costs, to incentivising companies to take on board and manage risks in exchange for reward.

Form of the price control. A price control is desirable which can respond to changing circumstances, avoid re-openers, and copes where the impact on costs is uncertain, building on the existing RPI - X + Q + L formula (where RPI-X covers a base level of service (at a low rate of return), Q = quality improvements (IIP) and L = losses).

Setting quality of supply targets. These cannot, and should not, be set on the basis of comparative analysis of companies' performance. This would represent an uncertain and 'moving' target. Targets must be absolute and specific to companies, for example based on companies' own performance over time.

It would be in the longer term interests of investment in the network, to set longer term targets for quality. It is also not evident that they need to be tightened.

Timetable and consultation for this year's work.

The Energy White Paper. The timing of the Government White paper could have a significant impact on the timetable. We urge Ofgem to press the DTI for guidance on this.

I hope that our comments above are helpful. We look forward to continuing constructive discussions with Ofgem on DPR4.

Yours sincerely

Rob McDonald
Group Regulation Manager