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369 - 07/08/02

Your ref

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Dear Cemil

Developing Network Monopoly Price Controls – Initial Consultation

I am writing further to the publication of the above paper on behalf of Western Power Distribution (South West) plc and Western Power Distribution (South Wales) plc.

Western Power Distribution (WPD) welcomes the publication of this initial consultation and agrees with the proposed objectives of the project. The process to date, including the two workshops that have been held by Ofgem and the ongoing communication with the EA Price Control Group has been very positive and constructive.

In assessing efficiency and projecting future costs for the forthcoming review it is crucial that a better understanding of cost drivers is developed. For example those costs that are fixed and those costs that are driven by either overhead or underground network length or asset numbers in order to ensure companies performance is considered on a level playing field. However, cost efficiency can only make sense in the context of the outcomes that a company delivers and valid comparisons can only be made with normalized (comparable) data.

Clearly a considerable amount of work needs to be undertaken much of which will now take place in the DNO working groups. WPD looks forward to its positive and constructive involvement with these groups.

Finally we trust that all parties will endeavour to meet the timetable as set out throughout the process in order to manage the inevitable workloads and burdens throughout this period.

Please find attached our detailed response to the initial consultation, which we are happy to be placed in the public domain. I trust our contribution is helpful and should you require any further information please do not hesitate to contact me.

Yours sincerely

R G WESTLAKE
Regulatory & Government Affairs Manager

Developing Network Monopoly Price Controls – Initial Consultation

Western Power Distribution's Response

SECTION 2 – Ofgem's proposed approach to undertaking price control reviews

Timetable and Consultation Process

Para 2.5 During any price control review process, it is important that any key policy issues are resolved as early as practicable. The methodology for determining quality of targets should be agreed, preferably before the completion of Business Plan Questionnaires.

Para 2.7 An open and transparent consultation process is essential as is the need for workshops, industry meetings, individual company meetings, publication of consultant's reports and explicit explanation of recommendations and proposals by Ofgem in their publications.

Key Issues for a price control review

Para 2.12 Interested parties must have a good understanding of the key issues for a price control review at an early stage of the process, ensuring the transparency that is essential to any review process.

Identifying price control principles

Para 2.13 In order to assess the efficiency of companies it is essential that a better understanding be developed of the cost drivers relevant to the business. A cost driver model, that normalizes data for individual network assets, when combined with the previous approaches to the assessment of capital and operating expenditure will improve the efficiency evaluation of each separate company.

Quality of supply targets should be set on the basis of comparative analysis using normalized data for assessing companies' performance thereby ensuring that companies are set equally challenging targets. The use of comparative data would be consistent with Ofgem's IIP proposal to reward frontier performing companies.

Identifying Outputs

Para 2.15 When considering the outputs that companies are required to deliver, the differentiation between physical outputs and outcomes adds clarity. We would recommend the following definitions for physical outputs and outcomes as:

- 'Physical Output' should relate to an amount produced, for example, amount of distributed generation connected or the number of new connections made; and

- 'Outcome' should relate to the results achieved, for example, minutes lost, number of interruptions

We would recommend that definitions are agreed at this early stage in the review process to ensure Ofgem and companies are using these terms on a consistent basis.

Identifying the incentive and price control framework

Para 2.19 The RPI –X price control regime remains the most effective means of incentivising companies to operate efficiently. The basic RPI - X regime could be refined, along the general lines outlined at the most recent Ofgem/DNO price control workshop, in order to ensure more focused incentivisation.

Para 2.22 Requests for information need to be 'focused' and provide an opportunity and appropriate amount of time for companies to comment on the draft information requests and draft business plan questionnaire. Focused information requests will be more readily achieved with a greater understanding of the cost drivers of the business.

Assessing efficiency and projecting future costs

Para 2.24 Assessing efficiency and projecting future costs for the forthcoming review is only possible if a better understanding of cost drivers is developed. The model produced should differentiate between relatively fixed costs and costs that vary with overhead or underground network length or asset numbers. WPD have used cost drivers models to accurately predict operating costs. The data used should have been compiled on a consistent basis.

Developing financial modelling

Para 2.26 The proposal to make available a version of the financial model and associated explanatory guide will increase the transparency of the review. The external audit of the financial models should be continued.

Assessing the review process

Para 2.29 Following completion of the review, the price control review process needs to be assessed, and interested parties provided with the opportunity to contribute to this assessment. This should lead to improvements in process and methodology for the future.

Monitoring price controls

Para 2.30 Companies' performance between reviews needs to be reported on an ongoing basis. It is essential that this does not place an unnecessary burden onto companies and should form part of the annual regulatory returns. The regulatory returns may need to be adjusted to reflect changes in the regulatory framework.

SECTION 3 - Review of existing network price controls

Consistency of price controls

Para 3.3 Consistency of price controls should be implemented where appropriate and we would welcome consultation arising from successful proposals and experiences within, for example, NIE or Transco's price control reviews.

Strength and Periodicity of Incentives

Para 3.6 – 3.8 In order to strengthen incentives for companies to achieve efficiency savings throughout a price control period, companies should be able to retain the benefits of cost efficiencies for a fixed period of time regardless of when the saving is achieved. The fixed period retention of efficiency savings could be achieved by using a rolling adjustment mechanism and would improve long term incentivisation. (As was implemented following NIE's recent review)

The distortion of incentives between capital and operating expenditure

Para 3.9 - 3.10 In order to incentivise companies to identify the most efficient mix of capital and operating costs, it would be appropriate to develop more balanced efficiency incentives between capital and operating costs. This could be undertaken in conjunction with refinements to the RPI –X regime.

Para 3.11 It is important to ensure an appropriate balance between short term and long term incentives. The RPI –X regime should be refined in order to provide the appropriate incentives for longer term performance and security of the network.

Assessing efficiency

Para 3.12 Validly assessing efficiency on a comparative basis will require:

- An understanding of which costs are relatively fixed and which costs vary with asset numbers (overhead or underground network length, switchgear or transformer numbers and so on)
- Data inputs that have been consistently compiled
- A normalised measure of the outputs achieved for the costs
- Separate assessment of both operating costs and capital.

Incentives to invest and quality and security of supply

Para 3.14 - 3.21 To ensure that companies have the right incentives to invest in a timely and efficient manner in order to provide a good quality of service to consumers and maintain system security a mix of initiatives is required. This mix would include:

- Incentivising companies to deliver results (i.e. outcomes such as Customer Minutes Lost per Customer);
- Incentivising companies to deliver physical outputs (e.g. amount of distributed generation connected);
- Set the target outcomes for a price control period within the context of longer term target outcomes; and
- Allowing companies to retain capital efficiencies for a minimum of 5 years (as was implemented for NIE following their recent review)

Other issues associated with capital expenditure

Para 3.22 Non-operational capex should be included in the RAV as the distinction between operational and non-operational capital expenditure is blurred and no longer appropriate. Expenditure on tools and network IT systems, currently treated as non-operational capex, adds value to the distribution business over several years as these assets are necessary to ensure the efficient operation of the distribution network.

The opening RAV value in the next price control period should be adjusted upwards to ensure that there is no loss in allowance from a change in treatment i.e. under the current treatment a full allowance is recognised each year, whilst under the proposed treatment the allowance would be amortised over a number of years

A depreciation life of no longer than five years would be appropriate for such expenditure.

Cost of Capital

Para 3.28 - 3.30 We welcome Ofgem's statement that the cost of capital is calculated on a “robust” basis and the UK’s utility regulators initiative to commission a joint study to determine a consistent and identify the best current approach to determining the cost of capital.

The methodology for setting the cost of capital should be transparent, rational and detailed enough for a DNO and its funders to predict future allowed returns with reasonable accuracy, thereby allowing decisions to be made in relation to investments whose return will be earned over several review periods.

For consistency Ofgem should assume a gearing level of 50% in its determination of the allowed cost of capital, even though a DNO’s actual gearing may vary from this level. It is important that Ofgem should continue to encourage a DNO to seek an efficient capital structure provided a DNO complies with its licence obligations to maintain investment grade status.

In determining the cost of debt we propose that Ofgem continue to assume a Standard & Poor's credit rating of BBB in determining the debt premium.

With respect to the cost of equity the principal issue is the fundamental change to the tax regime applying to DNO's that will take effect in 2005 and will significantly increase DNO's effective (cash) tax rates. The calculation of the "tax wedge" included in the calculation of the cost of equity will need to be amended to reflect the change. By way of background, the Inland Revenue will discontinue the 100% capital allowance on non-load related expenditure from April 2005. The impact of this changes will be to increase the cash cost of taxes to DNO's and will increase their actual cost of capital by between 2.5 % and 4 %.

<u>SECTION 4 – The next distribution price control review</u>

Objectives for the price control review

Para 4.9 WPD supports the high level objectives for the price control. However, it would be useful to develop complimentary quantifiable measures, for example, a measure of the suitable financial ratios that ensures companies can finance their licensed activities, say x times interest cover.

In addition, it is essential that the process is open and transparent.

Key issues for the price control review

Para 4.13 – 4.22 In order to facilitate the Governments targets for renewable generation and CHP, it is important that distributors are incentivised to connect generators to the network. Issues that need to be considered include:

- A higher rate of return on assets associated with the connection of generation to reflect the greater risk of generation closure over demand closure.
- A price control formula that allows additional income to be generated with the connection of generation. This is likely to require a 'kW of connected generation' driver in addition to the existing fixed, kWh and IIP drivers.
- Treatment of incidents in IIP, OS and GS where the incident is caused by the failure of a generator being used to support the network – exclusion of such incidents would incentivise the greater use of generation to support networks.

Whilst it may prove necessary to undertake a fundamental review of Engineering Recommendation P2/5 to incorporate the treatment of widespread distributed generation, we believe that such a review is unlikely to be completed in time to feed into a price control for implementation from 2005. The impact of distributed generation on capital projections will need to continue to be made against compliance with the existing P2/5 standard.

It is important to recognise that the level and nature of distributed generation that is to be connected to the distribution network is not the only source of uncertain costs. Companies can experience "cost shocks" from a variety of sources, for example change in legislation such as the New Roads and Street Works Act, the review of Energy Policy and bad debt due to failure of a supply business. A range of mechanisms that allow companies to recover these costs or mitigate them through, for example, insurance premiums, will be required.

The incentive and price control framework

Para 4.27 The RPI –X price control framework has been refined to cater for incentives to:

- Reduce losses; and
- Deliver quality of supply targets (i.e. outcomes).

The price control framework should be refined further to provide incentives that relate to the delivery of outputs.

Initial timetable for the price control review

Para 4.30 We fully support the publication of the timetable for the forthcoming price review early in the process. This will enable companies to plan ahead and to ensure the relevant staff are available/appointed to deal with the consultations and information requests as they are published. It is of course important that this timetable is adhered to as far as is practically possible by all concerned parties and any changes are indicated to companies at an early stage.

Para 4.33 Completion of the Business Plan Questionnaire is a hugely time consuming exercise and involves considerable resources. We would therefore appreciate the opportunity to comment on a draft as soon as possible. To spread the workload we suggest that any historical information requests could be issued well ahead of the main Business Plan Questionnaire.