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Cemil Altin  
Head of Price Control Development  
Ofgem  
9 Millbank  
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Our ref:AKP/SE

Dear Cemil,

### **Developing Network Monopoly Price Controls: Initial Consultation**

We are pleased with the scope and objectives of the project for developing price controls and support the co-operative and consultative approach you and Richard are taking to move the process forward.

The key issues identified for network monopoly price controls in general are all extremely applicable to distribution, and so we welcome the debate that has been started in your initial consultation. In particular we support the need to look at how incentives to invest in the network can be improved, given the major challenges facing the businesses over the next decade.

At present the need to meet current statutory and licence obligations, including the Information and Incentives Project (IIP), set out in the five year regulatory contract provides short term incentives, but with few drivers for the long term integrity of the network. Consequently asset replacement may be deferred increasing risk, but eventually prices will have to rise to fund the investment which will eventually be required to maintain network integrity.

We also agree with the need to develop the regulatory framework to deal with increased levels of uncertainty, not least caused by the growth of distributed generation. In order to meet the government's objective to increase the contribution of renewable generation to 10% of the UK's energy supply in 2010, significant investment in the network will be required. However whilst the RPI-X framework has removed inefficiencies inherited at privatisation, there are no incentives to meet this challenge currently.

Given the complexity of many of the issues raised in the paper, it is imperative that a comprehensive work programme and project plan is established within Ofgem. This would allow issues to be prioritised; in particular those which will affect

business behaviour during the current price control such as the application of rolling opex and capex adjustments, and these will need to be addressed as soon as possible in the process. Furthermore, by undertaking this exercise, it may become apparent that in order to ensure a satisfactory resolution to some issues, an extended debate beyond March is required, and that some issues may even remain unsolved for the next price control. It is important that throughout this project, Ofgem provides clarity and transparency on how key decisions have been taken.

In our view the key factors which we need to consider can be summarised as:

- Eliminating periodicity and the balance of opex and capex incentives
- Improving comparative analysis
- Introducing an appropriate quality incentive scheme
- Ensuring long term network development
- Financing of obligations
- Incorporating flexibility to the regulatory framework

Eliminating periodicity and the balance of opex and capex incentives

RPI – X regulation theoretically provides strong incentives to encourage companies to pursue cost efficiencies. However, for distributors, the benefits from beating the operating cost forecast are only currently retained for the duration of the price control. As the paper recognises, the incentives to make savings may diminish through time, making it more attractive to undertake these in the first couple of years of a price control. For example, the company retains 27% of the present value of a cost reduction made in the first year of a price control period and only 6% of the present value of a cost saving made in the fifth year.

Year of saving	1	2	3	4	5
% of perpetuity value	27.0	22.3	17.2	11.8	6.1

Some investment decisions that could lead to further opex savings towards the end of a price control period may therefore be delayed as a reaction to a declining pay back period. We therefore support the NAO recommendation to remove timing distortions that currently persist due to the regulatory timetable. This could be achieved by allowing companies to retain efficiency savings in excess of regulatory assumptions for a fixed period of time, or use of a rolling average, before being passed to customers.

We agree with you that the present arrangements give rise to unbalanced incentives between operating and capital expenditure. The paper separates this trade-off into operational and accounting factors. Whilst capital expenditure incentives were strengthened at the last distribution review by allowing companies to retain efficiencies (depreciation and rate of return) for a fixed five-year period, they remain insufficient to address the operational trade-offs. This has potentially contributed to an inefficient mix of inputs and higher prices to customers in the long

run; of course, the introduction of a rolling opex mechanism may further compound this issue.

Whilst additional disclosure within the new Regulatory Accounting Guidelines (RAGs) is a step forward, we cannot expect this to provide significantly greater consistency in the allocation of costs between operating and capital expenditure. This is particularly true where activities have been outsourced by the distributor which will validly incorporate capitalised costs, especially overheads, previously accounted for within opex. Hence the reporting of operating costs and capital expenditure will remain inconsistent between companies, making sensible comparisons extremely difficult and vulnerable to inaccuracies if they continue to be assessed separately.

The framework should therefore be improved to mitigate these distortions, otherwise future customers will finance an increasingly large and arguably unhealthy proportion of current spending. An extension of the period for retaining capex efficiencies would go some way to redressing the balance of incentives. We also welcome your suggestion to consider measuring performance on the basis of total costs as this would reduce the impact of differing capitalisation policies and outsourcing solutions, which are unrelated to efficiency.

#### Improving comparative analysis

Assessing efficiency on the basis of operating costs as discussed above has distorted incentives on companies to substitute capital for operating expenditure. Companies may therefore be perceived as being efficient on an operating cost regression whilst delivering higher prices to customers over the longer term. We therefore support the high priority ascribed to improving comparative efficiency analysis including the benchmarking techniques employed.

A total cost approach, combining both operating and capital expenditure, would ensure that companies adopting a high replacement strategy would be comparable with those choosing a high repairs and maintenance policy, whilst also addressing accounting issues discussed above. However, there is an ongoing debate on how to incorporate capital expenditure within a total cost approach, whether it be on a five year average, only includes non-load related expenditure etc. Investment programmes are characterised by a lumpy profile, and hence assessing efficiency according to one year's capex performance is likely to distort the results. One possible method is to undertake the assessment on the basis of allowed revenue, combining the financing costs, depreciation and operating costs, which would address this issue, and accommodate past investment since Vesting.

There are however limitations with each of the approaches discussed which will need to be addressed:

(a) Applicability to an NPV framework

It is unclear how a total cost or allowed revenue model would be accommodated within an NPV framework. Using a total cost approach would require the degree of efficiency to be allocated between opex and capex. Whilst this requires further thinking, in contrast to assessing opex and capex separately, it provides a more balanced approach.

(b) Normalisation of inherent and inherited factors

At current levels of expenditure, it would take over 70 years to replace our entire network. Hence inherent and inherited factors, prior to Vesting, will therefore need to be taken into account prior to undertaking any meaningful comparison of efficiency. This, of course is particularly relevant if capex is brought into any comparative analysis.

(c) Mergers

The assessment of efficiency is further complicated by the impact of corporate transactions. Benchmarking should not incentivise companies to merge, and hence this should be adequately reflected in the analysis. A mechanistic approach to estimating these benefits is unlikely to be sufficiently accurate to be applied to the analysis. Such benefits will also need to be re-assessed when adopting a total cost or allowed revenue approach.

(d) Cost drivers

We welcome the intention of Ofgem to gain a better understanding of cost drivers. In moving towards a total cost or allowed revenue approach, however, such cost drivers will need to incorporate factors that are driving network investment as well as operating costs.

We therefore recognise that no single model should be relied upon to explain performance. Given the issues raised above, a number of approaches to assessing efficiency will need to be considered. Also a more robust analysis of a company's cost base should be undertaken in a bottom up assessment of efficiency, improving on that that was done at the last review. The degree of explanatory power from any analysis nevertheless should be reflected in the conclusions drawn for setting future allowances.

Introducing an appropriate quality incentive scheme

The IIP is designed to ensure that companies meet or exceed quality of supply targets for the number and duration of interruptions. The original targets for the period up to 2004/05 were set on the basis of a percentage reduction from a 10-year trend for each distributor. However, this method suffered from a number of problems. It assumed that accuracy was comparable across the industry, but experience of the IIP project shows that this was not the case. Also the last review ignored the fact that the marginal costs of incremental change differ between

companies, all companies being given comparable allowances. Furthermore there was no attempt to link the costs of incremental improvement with customers' willingness to pay for this.

We support Ofgem's intention to carry out research on assessing customers' willingness to pay for quality of service. However we believe the approach used in the Water Supply Industry should be applied here, whereby Ofgem and the distributors jointly undertake the research. The objectives of the research could then be agreed by all stakeholders and incorporated within the terms of reference, which would enhance the credibility of the conclusions. In considering the outputs that customers' most value, this research is an ideal opportunity to evaluate customer's views on longer-term security and integrity, and whether they would be prepared to finance investment in these areas.

The paper suggests that quality of supply could be reflected in any assessment of efficiency. This assumes significant progress has been made on accuracy of counting and normalisation of cost and service for inherent and inherited factors. Without properly reflecting this in the analysis, some companies will face the risk of being unfairly penalised, creating additional uncertainty and risk over and above that which is consistent with a 6.5% cost of capital.

Given our current level of understanding of these issues, we believe any inclusion of quality within a comparative assessment is unlikely to be sufficiently robust to be a feature of the next price control review. The future incentive scheme should therefore be set on the basis of a company's marginal cost in making incremental change to the network, consistent with the marginal benefits received by customers.

#### Ensuring long term network development

Whilst we support RPI – X as the main component of the next price control, the current five yearly settlement conflicts with the long term development of the network with little incentive to invest beyond the current review due to:

- Uncertainty over the treatment of additional investment in a total cost assessment of efficiency
- Uncertainty around the form of the IIP post 2004/05
- Potential for ad hoc penalties displayed in the last review

We welcome your recognition of the need to continue to improve the incentives that companies have to invest in the network. We also agree that there may be merit in setting longer term service targets with associated capex allowances, which would enhance certainty for developing our investment plans. Within such a longer term framework a rules based mechanism, such as an error correction model, would be one way of dealing with changing circumstances over this longer-term horizon and for sharing the benefits of out-performance with customers. Any possible new obligations such as these may require different incentives from those associated with the traditional RPI - X framework.

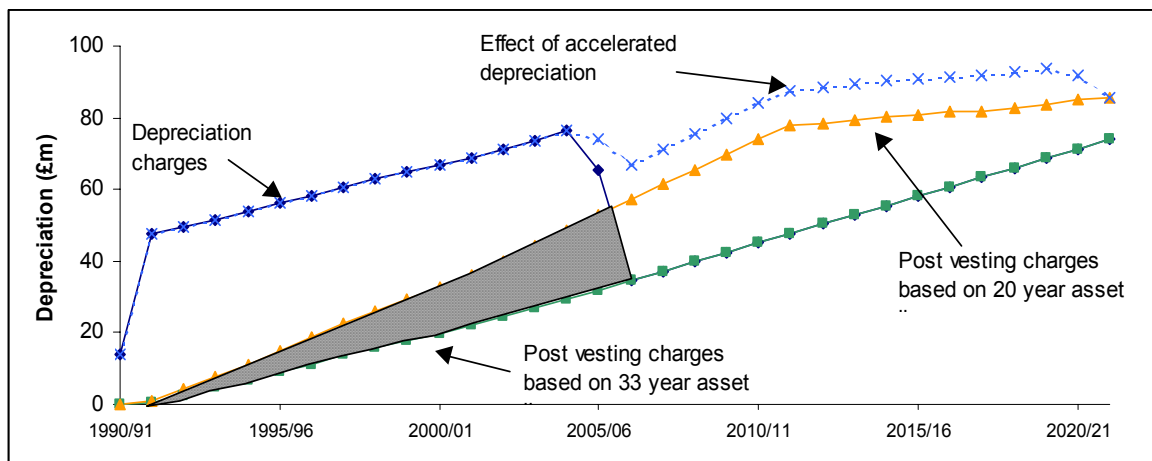
## Financing of obligations

Ofgem has a statutory duty to ensure licence holders are able to finance their statutory and licence obligations. There are a number of financial issues that will arise during the review, which has the combined effect of tightening the regulatory regime. These concern

- Depreciation
- Tax
- New licence obligations

### (a) Depreciation

At the last price review Ofgem recognised that there will be a problem when pre-Vesting assets are fully depreciated. Without any action, depreciation charges would more than halve before increasing steadily until a steady state is reached. An acceleration of depreciation charges through a change in the regulatory asset lives, from 33 to 20 years, was announced at the last distribution review as a means of addressing this issue for the companies affected during the 2000-05 period. However, since this only partially mitigates the problem as shown below, we would urge Ofgem to consider further smoothing of the depreciation profile to minimise the volatility in future prices. Furthermore, accelerated depreciation will reduce the Regulatory Asset Value (RAV) significantly over the longer term. This will have implications for the potential returns that can be earned by investors in the future, which were perhaps not considered fully last time around.



### (b) Tax

Since privatisation, distributors have had an agreement with the Inland Revenue in respect of the tax treatment for replacement assets. The Non-Load Agreement will however be terminated on 1 April 2005, leading to a substantial increase in taxation, impacting on earnings, and hence levels of debt and gearing. We would therefore urge that this issue be brought into the framework for consideration at the next review.

### (c) New licence obligations

As we have highlighted, there are a number of new obligations that will increase the financial pressures on companies. Additional investment to replace and enhance network assets will be required to support distributed generation, maintain long term security of supply and potentially deliver service improvements to specific groups of customers.

In order to ensure that the right balance is made between current and future customers financing these new obligations, it may be appropriate for a proportion of capital expenditure to be funded up-front on the basis of “pay-as-go”, and to introduce contingency margins where long term cost forecasts are made.

There should also be a distinction between the costs of financing the existing and future RAV. The financing of the existing RAV is backward looking and largely a matter for rate of return. A different cost of capital with separate incentives could then be applied to enhancement expenditure based on the associated risks of these specific projects. For example, there is the potential for stranded assets and costs from the growth of distributed generation. If the costs of investment are factored into a generation RAV, the risk is spread over a much smaller, less dynamic customer base compared to a demand RAV. This would require appropriate incentives to enable us to respond to the challenge set by the government and Ofgem.

We appreciate your proposals to publish more information on the financial models being used at the next review. Over time such analysis has become key with a low cost of capital, high gearing, and increased investment demands. Given these issues, and the lack of growth in the RAV with accelerated depreciation, it may in future be necessary for future price controls to be predominantly self-financing.

### Incorporating flexibility to the regulatory framework

As discussed earlier, RPI – X has been highly successful in eliminating inefficiency from the industry. However, continual reduction of cost and resources has eroded any contingency to react to changing and unforeseen circumstances, which must now be factored into the existing framework. We are therefore encouraged that, where it is appropriate, Ofgem will seek to put in place mechanisms that allow companies to respond to these situations.

We believe that if the company is best placed to manage the risk, appropriate incentives should be created as you suggest in the paper. However it is important to strike the right balance between companies and customers, and hence the application of sensible caps and collars deserves consideration, consistent with the risk profile. Where the time horizon for delivering investment is long, and hence the cost projections are vulnerable to significant risk, contingency margins may be a useful tool for reducing this risk for companies. In the case of a low risk business such as distribution, it is also appropriate that where it has no control over managing the risk, these should be borne by customers.

Distributed generation is one specific uncertainty raised in the paper, but it is by no means the only one. In order to meet the challenge set by the government's 2010 renewable target, further investment in networks will be required, both to connect new generators, and in developing the network to accommodate the output of distributed generation. Considerable risk is introduced, including the speed of growth of distributed generation / micro CHP, and the possible impact it might have on revenue. Some companies may be prepared to take on more risk in exchange for a reward for outperformance, whereas others may have a more risk averse approach to dealing with uncertainty. One way to reconcile these differences is to allow companies to choose between different risk/reward packages through an appropriate incentive mechanism.

### Conclusion

In conclusion, Ofgem's initial consultation provides a very useful starting point in setting out the process and key issues. The suggestion of collecting information at different stages of the review, such as separating the business plan questionnaire into historic and forecast information deserves serious consideration. However we are concerned that many of the issues raised in the paper are complex, and require significant resources to satisfactorily address them. We reiterate our view therefore that this project requires effective programme management, and that the key issues should be prioritised according to the impact they have on current business behaviour.

If you would like to discuss any of these issues feel free to contact me on 0121 530 7572.

Yours sincerely

Andy Phelps  
Regulation Director