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Our ref:AKP/SE

Dear Adrienne,

### **Developing Network Monopoly Price Controls: Update Document**

We are pleased to see that you have set out a draft framework for the next two years, which will provide a firm foundation from which to start the next distribution price control review. The document highlights the need to allow an appropriate amount of time for companies to respond to information requests for the BPQ. We welcome this and support the splitting of data between historical and forecast information.

However, we must now agree on the key objectives and issues for the next price control period which should form the focus for the BPQ to avoid unnecessary and excessive data requests. To ensure this, each requirement in the BPQ should be justified against these objectives and policy for the review. The detailed development of incentive regimes can then be worked upon over the next year, using the Frontier Economics reports on uncertainty and incentives as a guide to informing policy in these areas.

We have a number of key issues with the framework for the review, which are discussed below, and have provided further detailed comments in an attachment.

#### Cost comparisons

We are supportive in principle of total cost regulation, providing a more comprehensive view of efficiency, but accept that there are issues regarding the definition to be used. We would hope that the May 2003 statement document would inform us of Ofgem's thinking on this issue but caution against relying on any one assessment of efficiency in a mechanistic way, since there is no one correct methodology. Furthermore, without any accurate assessment of merger efficiencies, the comparative analysis of cost performance will produce perverse outcomes, which will discriminate against single licence companies. Moreover

without any informed adjustments, it will simply encourage further consolidation within the industry. We also welcome Frontier Economics' report on incentives, which embraces the application of an average cost yardstick for improving the incentive power of the regulatory regime, and believe this should be the basis for setting future cost allowances.

### Incentives and sharing factors

The industry inherited inefficiencies at privatisation, and evidence since 1990 has shown that distributors have made major strides in removing these through continual outperformance of the regulatory regime. Looking ahead, the framework should recognise that it is getting increasingly hard to squeeze out further efficiencies. One way of addressing this is to reflect it within the timeframe that shareholders can retain the efficiencies from outperforming the regulatory contract, before sharing these with customers. Whilst we support the commitment to expand the rolling mechanism to opex, we believe that a sharing factor of 50:50 is appropriate for the future, so shareholders and customers alike equitably share in future efficiencies.

### Quality of supply targets

Frontier have pointed out in their report on incentives that if a relative cost regime is used, it would not be appropriate to adopt a similar approach to quality. Notwithstanding this argument, such an approach is not possible without a robust understanding of service drivers. As the working group on comparing quality of supply performance has shown, disaggregation does not allow for this, but can be used to inform comparison at a detailed level. It therefore follows that quality should be dealt with separately and future targets set on the basis of closing performance variation at the disaggregated level, commensurate with the required investment and customers' willingness to pay. Fundamentally, we believe the IIP and rolling capex schemes provide sufficient incentives to address the tensions between cost and quality. We also believe that capex efficiency savings should generally be reflected in the rolling mechanism, with any deduction from a failure to meet IIP targets being considered on a case by case basis and scaled appropriately to mitigate the risk that has effectively been doubled in your proposals.

### Financing issues

Any proposed outputs from the price control review must be fully tested against a robust financial model to ensure that companies can maintain an investment grade rating, to meet their financial obligations and ensure that an appropriate equity return is generated for shareholders. The debate on the cost of capital will be key to achieving this. The Electricity Association has commissioned a study on the Cost of Capital which has identified two key areas where circumstances have changed since the last regulatory review. Both the forward looking equity risk premium and the debt premium should in our view be increased to reflect recent market evidence, including the deterioration of credit ratings. This is consistent

with the equity risk premium and cost of equity contained within the joint regulators report produced by Smithers and Co.

There are also a number of factors in the near future that will adversely impact revenues significantly, such as the depreciation cliff face and increased tax and pension liabilities. Combined with uncertainty regarding amongst other things Distributed Generation and Lane Rental, and the prospects of significant increases in investment to achieve a sustainable network, it is important that these objectives can be financed, whilst providing scope for an average performing company to earn a rate of return commensurate with the allowed cost of capital.

We look forward to discussing some of these issues with you in our 28<sup>th</sup> April meeting.

Yours sincerely

Andy Phelps  
Regulation Director

## Detailed Comments on the Consultation Paper

***“Whether there are any aspects of the electricity transmission framework that should be applied in electricity distribution and the most appropriate timing for doing so”.***

The August consultation made clear the differences in approach to regulating gas and electricity transmission and distribution. Our view is that where there are benefits of adopting a consistent approach, they should be teased out during this review process. A good example is to adopt a common methodology for deriving the cost of capital.

The scope for replicating the transmission framework to electricity distribution, however is limited, at least in the foreseeable future. Whereas transmission is essentially a single network with entry and exit nodes, distribution exhibits radial characteristics with a number of different voltage levels. These specific factors are likely to dictate local solutions, and we would therefore not support consistency for the sake of it.

Dealing specifically with the current arrangements, it is doubtful whether market based access rights would incentivise efficient investment on the distribution system. To work effectively, such a market would amongst other things require demand at defined access points and a spot market or something akin to it. Furthermore, “firm” access rights would need to be clearly defined and need to reflect section 21 Electricity Act which protects distributors from compensating holders for economic loss.

A comprehensive regulatory impact assessment would need to consider whether the benefits of a separate system operator outweighed the costs. One of the questions that would need to be addressed is the definition of an active system operator. Given that this may differ from transmission, it may not necessarily follow that separation from the asset owner is an optimal policy response.

### **“Dealing with uncertainty”**

We have found this framework for developing policy with regards to uncertainty a helpful contribution to the debate. Indeed, our response to the CEO letter on Distributed Generation used the framework in order for us to consider an appropriate response to the issues highlighted. Our proposal for dealing with exceptional events is also derived from this framework.

The characteristics by which uncertainty can be described are largely captured in the report by Frontier Economics. However we are not convinced as to the usefulness of including diversifiability in the analysis. Financial theory would suggest that investors could diversify risk by holding a portfolio of investments across the industry. Whilst in theory we accept this point, diversification is not practicable as many of the distribution companies are not directly quoted on the stock exchange.

Our other comments on the framework relate to the ability to separate, control and predict the impact of the event. This is likely to be imperfect rather than simply a yes/no answer in the decision tree process. Therefore turning this into practice is likely to be challenging, although we would expect Ofgem to apply it to any proposals to help inform and construct an appropriate policy. In our view the decision tree should be used as an aide rather than a prescriptive mechanistic tool, requiring trade-offs on the risk-reward spectrum of incentives. The next stage of the process is for Ofgem to codify how they will treat areas of uncertainty, along the same lines as Ofwat are adopting for their 2004 review, otherwise risk is not being reduced and will need to be reflected in a higher cost of capital.

In terms of its application to Distributed Generation, we agree with Frontier Economics that the short term regulatory regime should be company specific. We have argued this because the costs are not predictable or controllable initially, and therefore should be passed through to customers. An alternative remedy is to set a high unit cost driver sufficient to cover uncertainty and to promote efficiency. Such a profit-based incentive is necessary to reveal information regarding the volume of connection and cost of reinforcement from distributed generation. As more information about cost drivers is known from experience, the incentive framework could be refined accordingly.

Frontier Economics also discuss the increased use of benchmarking over time. Whilst this allows common cost shocks to be passed on, the model will require considerable understanding of cost and quality drivers. Given the difficulty in comparing costs for the main feature of the price control, inaccurate benchmarking for Distributed Generation will increase risk significantly, and is therefore some way off.

***“The most appropriate balance protecting consumers and providing companies with incentives towards efficiency and in particular the length of time that companies should be allowed to retain efficiency savings”.***

Efficiency savings should be made as and when opportunities arise, and should not be delayed as a consequence of the regulatory framework. We therefore welcome Ofgem’s policy of allowing companies to retain the benefits of both operating and capital expenditure for a fixed period of time, as a means of addressing the issue of periodicity. However there is now a need to develop a mechanism to properly implement this policy.

The incentives on managers to continually seek out efficiency savings prior to privatisation were limited at best. Over the last twelve years, the regulatory framework has encouraged companies to reduce costs, maximise profit and latterly to increase quality of supply. Companies have responded to this set of incentives by outperforming the regulatory contract. At the same time, customers have experienced a 50% real reduction in DUoS charges. However as significantly more effort and investment will be required in the future from managers to stimulate continued improvement, as acknowledged by the Frontier Economics report, the benefits from outperforming the regulatory contract should be retained

by companies for a longer period before being shared with customers. We believe that customers and shareholders should share an equal proportion of the efficiency benefits and therefore favour a 50:50 approach for both operating and capital expenditure.

#### (a) Average cost yardstick

Rolling mechanisms address the issue of periodicity and as such increase the incentive power of the regulatory regime. However, as the Frontier Economics paper discussed, this in itself is not an optimal solution. The additional effort required to seek out more challenging and innovative efficiency savings will require a higher powered regime. We therefore advocate an average cost approach to resetting allowances every five years.

Under this regime, cost savings would be retained for a fixed period of time, while future allowances be set on the basis of average rather than frontier costs, as the Frontier Economics report suggests. This approach is consistent with the operation of competitive markets. Companies with below average costs would earn higher than average rates of return. Applying this principle to a regulated industry requires the cost of capital to be aligned with the average cost yardstick. This will provide opportunities for individual companies and the industry as a whole to be appropriately rewarded for outperformance, whilst being able to share the benefits with customers, as acknowledged by the Frontier Economics report. If this approach is not adopted, there is considerable risk that innovation will be stifled because the level of reward is not commensurate with the risks and effort required to deliver such desirable benefits to customers.

Another benefit of setting future allowances according to average cost is in regards to modelling efficiency. We have previously raised our concerns about the robustness of comparative cost data. By adopting an average yardstick, these risks are reduced compared with a methodology based on setting allowances in relation to frontier costs. However there remain significant risks if the cost drivers are not robust for making sensible comparisons. Furthermore, our own analysis has shown that efficiency results are sensitive to the models used such as DEA, corrected OLS and stochastic frontier analysis. Ofgem should therefore use a number of approaches to inform the debate on comparative efficiency, rather than used mechanistically for setting future allowances.

#### (b) Total factor productivity

Turning to the basis of setting the productivity assumption when rolling forward allowances, the distribution sector has made significant improvements over the past ten years and ought reasonably to be viewed now as no less efficient than the average of UK industry. It seems appropriate therefore to forecast this annual shift on the basis of total factor productivity (TFP) measures for the UK. This provides clear incentives for companies to reduce costs at a rate that exceeds the average TFP and hence earn above average returns, whilst passing on some of the benefits of ongoing cost saving initiatives to customers during the forthcoming price

control. Given that general productivity is already factored into RPI, this implies that X should be zero, subject to the ability of companies to finance their activities.

***“The most appropriate way of reducing the distorted incentives between opex and capex”.***

Where there is no trade-off between operating and capital expenditure, there is no need to consider the different sharing factors. However where decisions on capital expenditure impact on operating costs and vice-versa, the incentives need to be balanced to avoid distortions. The current regulatory framework provides greater benefits for companies to make an operating cost saving as opposed to capital efficiency. We therefore agree with Frontier Economics’ conclusion that where there is a choice between a one-off £1m operating cost or capital expenditure saving, the company will seek to capitalise costs. For example when a £1m operating cost saving is made, 100% of the saving is retained by shareholders compared with £380,000 (38% sharing factor) if the saving was attributed to capital expenditure efficiencies.

We were however surprised that the report concluded that if a one-off capital investment is being considered to achieve a permanent reduction in operating costs the “strength of the incentive to make efficiency savings is comparable”. As a five year fixed retention of the efficiency savings and costs produces different sharing factors for operating and capital expenditure for example, savings will need to exceed the level at which the scheme would be viable under an NPV appraisal of investment.

Overall, the Frontier Economics report is a valuable contribution to the debate, and we draw from the conclusions that capital efficiency incentives need to be strengthened beyond the incremental steps taken at the last price control review. Nevertheless when reviewing the balance of incentives, it is important to recognise the inter-relationship between cost and other factors. Careful design of incentives is necessary to minimise the potential distortion, and trade-offs are therefore an inevitable outcome.

***“Ofgem’s intention to allow companies to retain efficiency savings for a fixed period of time”.***

**(a) Rolling Opex mechanism**

We welcome Ofgem’s commitment to retain operating efficiency savings for a fixed period of time. However we believe this should be applied retrospectively from April 2000. It would seem perverse if efficiency savings made in March 2003 were retained for two years whereas savings made in April 2003 are kept for a fixed period, as yet to be determined.

Although the mechanics of the rolling scheme are able to deal with declining costs, care must be taken to ensure that cost shocks and new obligations are appropriately dealt with in the model. The unpredictable nature of the costs should be ring-fenced outside the rolling mechanism.

## (b) Rolling Capex mechanism

Whilst the commitment to a rolling mechanism is supported by Aquila, it would be inappropriate if it reinforced the benefit of an operating cost saving over the benefit of an investment saving. Our belief is that the retention period for capital expenditure savings will need to be in excess of five years to counter-act the strengthening of operating efficiency incentives, as the current incentives are already unbalanced. This however is only part of the solution, which in general requires a framework allowing all companies to minimise total costs, as we discuss below.

The incentive payment for capital efficiencies should be based on companies being able to retain the benefits of higher depreciation charges and a return on the savings made, for a fixed period of time. In the consultation, a distinction was made between a company delivering an investment project for a lower cost and the deferral of investment. Short term deferrals however can arise out of legitimate efficiency exercises such as enhanced condition based monitoring funded from operating costs. Given the trade-off between these two types of expenditure, the benefits of deferral would need to be included as a genuine out-performance of the regulatory contract to act as a counter-weight to the effects on the IIP. This would also avoid an overly bureaucratic monitoring of companies performance, which is both costly and places a heavy burden on companies and regulator alike.

The document also sets out that the IIP targets for the number and duration of interruptions will need to be achieved to benefit from the rolling mechanism. This implies that companies risk is effectively being doubled compared with that which we agreed to in DPCR 3, via:

- penalties imposed under the IIP regime
- clawback as savings are not retained for a fixed period

In principle, we do not support the additional risk imposed by aligning the rolling incentive mechanism with IIP. Only a small proportion of investment is incurred for quality related issues. Therefore if you fail to meet the IIP targets, you should still be able to receive some benefit from efficiencies in non-quality related investments. Therefore we believe that if a relationship with IIP performance is made, it is important that the risk is minimised through the application of a sliding scale mechanism. Companies that narrowly missed their final IIP targets should be allowed to keep most of the efficiency savings for a fixed period. Moreover it may be appropriate to review the reasons for failure on a case by case basis. Principally we believe that when efficiency savings are made, they should generally be reflected within the rolling mechanism, consistent with the principles of light touch regulation.

***“Whether it would be appropriate to provide more balanced incentives between opex and capex and the impact that this could have on retention periods and the incentives that companies have to provide a good quality and security of supply”***

(a) Total cost regulation

The objective of the regulatory framework should be to minimise total costs whilst delivering a set of outputs that customers value, along with a sustainable business environment. This would avoid the perverse incentives that arise from separate benchmarking of operating and capital expenditure. The Ofwat approach maintains separate benchmarks of costs, and adjusts the efficiency results to account for trade-offs. Although this will partly address the concern of unrealistic benchmark targets, the risk still remains that the adjustment will not be sufficient and will retain unbalanced incentives between operating and capital expenditure.

A cash cost approach, as the Frontier Economics report confirms, does not take account of investment in previous periods. Simply adding one year’s capex to opex will therefore lead to distorted efficiency results. Investment is by its very nature lumpy, and so some form of averaging would need to be used if such an approach were to be considered.

However, we support a form of total cost regulation where a stream of annual investment is converted into capital stock from which capital is consumed, reflecting depreciation and a return on the asset base. It is also important that any assessment of efficiency is able to reflect the fact that newer networks inherited at privatisation will require less operating and capital expenditure compared with older networks. A failure to adjust for these factors that takes decades to address, will produce perverse and statistically unsound results. We are therefore pleased that the report attaches importance to inherited factors, as well as the need to understand the inherent factors and their drivers that affect total costs.

(b) Consistency with the NPV model

Although we are supportive of Ofgem’s rationale for assessing efficiency on the basis of total costs, there are a number of issues raised above that will need to be addressed. There is also the problem as highlighted in the Frontier Economics report, of applying the results to a building block approach. One possible way forward would be for companies to choose the mix of inputs, against total revenue output targets. Data envelopment analysis could be employed as it can handle multiple inputs, and hence arrive at an efficient envelope of input mix. An alternative is to allocate operating and capital efficiencies on a consistent basis as a company’s management extends similarly to both. All of this suggests that for the next price control, total cost modelling can only be used as part of a set of models to inform the debate and for applying sensitivity analysis.

(c) Treatment of mergers

Another sensitivity that will need to be reflected in the analysis is the impact of mergers. At the last review, there were twelve independent observations incorporated within an operating cost regression, the efficient two being inexplicably left out. Merger transactions which have taken place since have reduced the number of independent management teams to eight. Our concern is that without an accurate assessment of merger efficiencies, the results will lead to perverse outcomes. This must be informed by modelling efficiency based on the number of independent management teams.

(d) Quality of supply

We support Frontier Economics' conclusions that if relative cost performance is used to inform future allowances, company specific targets should be set for quality of supply, to prevent either firms providing too much or insufficient quality, and hence leading to perverse and confused incentives. Distributors should nevertheless have the flexibility to optimise between capital expenditure and quality via the IIP and the subsequent impact on the rolling capex mechanism. We are not convinced that it will be possible to place a robust monetary value of CIs and CMLs to the cost base because of the problems surrounding the normalisation of data. For the same reason, using quality of supply as an explanatory variable in the efficiency assessment would produce unreliable results without a robust understanding of service drivers. Consequently we do not believe there is any merit in undertaking a value for money assessment at this time.

***“The treatment of the OSs and whether they should be included in the IIP incentive scheme”***

The IIP incentive scheme provides financial incentives on overall performance regarding the number and duration of interruptions to supply. Whilst the consultation explores the possibility of including ‘Overall Standards’ within the IIP, the scope of the customer research should inform what customers ascribe as the key outputs of the distribution business, and hence their inclusion in a future IIP. Furthermore, the existing IIP outputs capture the effects of OS1 for restoring supplies within 18 hours and therefore inclusion within a future financial incentive regime would double the risk for distributors.

The customer survey should include customers views on improving short term quality of supply measures and the resilience of the network; reductions in technical losses etc. The method for assessing customers' preferences seems reasonable. However last year we undertook on behalf of the EA some research on the different survey techniques that could be applied for assessing preferences, which was subsequently passed onto Ofgem. A conclusion that we drew from this piece of work was that stated preference surveys based on choice experiments were most applicable to a natural monopoly, and produced statistically significant results. We therefore look forward to contributing towards the terms of reference for the survey, and anticipate that these comments will be reflected in its design.

Any new outputs ascribed to the IIP will need to be audited for sufficient accuracy. Consequently there may be a delay in introducing new incentives whilst measurement systems and processes are reviewed to ensure compliance.

***“The most appropriate way of setting targets for the number and duration of interruptions to supply”***

The working group on Quality of Supply has already shown that disaggregation of performance does not enable the normalisation of performance nor derive benchmark performance. However it does provide for a more informed assessment of companies’ quality of supply performance. We have been supportive of this work, and believe that a detailed analysis can be used to identify key drivers at a detailed level of performance variation into either reliability, number of customers affected by an incident, or response times.

It would then be possible to develop targeted and cost effective strategies which reduce the variation in performance between companies, consistent with an appropriate investment allowance and customers’ willingness to pay. Given these issues, ‘frontier performance’ cannot be assessed on a relative basis but on the improvement made by companies since the establishment of these targets.

Furthermore, there is a need for a longer term framework to achieve sustainability of the network and to promote investment in the future. This requires the adoption of targets significantly in excess of the current 5 year horizon. These will have to be supported by an appropriate glidepath, and hence interim targets, consistent with the principle of sharing benefits with customers. Fundamentally, companies must be encouraged to invest where the marginal benefit to customers exceeds the marginal cost of improvements. However given the difficulty in predicting a target, it will be important to retain appropriate caps and collars to protect both customers and shareholders from undue risk. Finally, as time series quality data becomes more robust through the output of IIP, it would be possible to adopt a moving average for calculating annual performance, so that annual volatility can be smoothed.

***“The scope and form of the exemptions under the GOSPs and the exceptional circumstances mechanism under the IIP”***

The October 2002 storms brought into focus the current scope and form of exemptions to the GOSPs and IIP. We accept that a system needs to be in place that avoids customer confusion which detracts from their perception of the industry. The Frontier Economics report on uncertainty has put forward a framework for dealing with severe weather exemptions, which we believe in principle, is applicable to both guaranteed standards and the IIP.

The willingness to pay survey should be used to help inform whether predominantly urban customers would be willing to insure largely rural customers for loss of supply. Provided this is the case, we would be prepared to facilitate such a policy, effectively compensating all customers interrupted in excess of 18 hours under GS 2. The uncontrollable cost elements of severe weather would be

passed through while the controllable components are incentivised. Companies would then choose between making reductions in operating and capital expenditure and minimising compensation payments by improving the resilience of the network and reconnecting customers swiftly. Fundamentally, however, the design of the scheme must not extend the risks from the current arrangements, consistent with a low risk business, to avoid impacting upon the cost of capital.

For IIP, we are supportive of the rules based approach being proposed by MM/BPI.

***“The implications of the financing obligations and duties on Ofgem and licence holders”***

(a) Current regime

In accepting the DPCR3 regulatory contract, companies assessed the complete package. Whilst operating and capital expenditure targets were challenging, with a steep glidepath and no one-off contingencies, we were only required to move 75% of the way to a fixed frontier, and a tax wedge was provided for within the cost of capital derivation. Consequently there was enough scope for us to meet the contract and provide a reasonable return for investors. However if any of these parameters change in the future, it will adversely affected our ability to finance our statutory obligations.

(b) Cost of capital

Most studies into the calculation of the Cost of Capital to be used for regulated business adopt the Capital Asset Pricing Model (CAPM) although other methods are often used to support the outcome. In all calculations, a number of estimates and assumptions are required which result in the outcome being a range with a significant difference between the extremes. To underestimate the cost of capital, perhaps by using a figure towards the bottom end of the ranges, particularly during a period where the requirements for investment are increasing, could cause DNO's significant financial issues, problems with the retention of investment grade credit ratings, and would inevitably result in the required investments not being made. Ofgem must therefore ensure that in setting a cost of capital, they err on the side of caution.

Working in conjunction with the Electricity Association (EA) we have recently commissioned a study into the Cost of Capital for Distribution Network Operators. The outcome is consistent with both the study commissioned by the Joint Regulators Group and recent regulatory determinations, most notably the Competition Commission reports on water, airports and mobile network operators.

There are nevertheless two key areas, namely the Equity Risk Premium (ERP) and the debt premium, where the report argues for different parameter estimates relative to the Ofgem decision at the 1999 DPCR. To the extent that Ofgem may have correctly estimated the ERP at the last periodic review, there is now sufficiently strong evidence that the forward-looking ERP should be set at a higher

level. The midpoints of the ERP and Cost of Equity ranges recommended in the EA report are similar to those produced by the Smithers and Co report.

With respect to the debt premium of DNOs, it is argued in the EA report that the appropriate premium is at least around 200 basis points, excluding any adjustment for embedded debt and issuing fees. This is slightly higher than the 170–185 basis points allowed by Ofgem at the last periodic review (including adjustment for embedded debt). The main reason for this increase is the deterioration in the credit ratings of DNOs since the last review. We therefore trust that on receipt of this report, you will consider its conclusions carefully.

(i) Taxation

Looking forward to DPCR 4, the changes to the taxation regime, and most notably the tax treatment of infrastructure renewals from April 2005, will significantly increase the tax liability for companies. The projected tax cash rate will increase further if proposed changes to the capital allowance regime, mooted under the Reform of Corporation Tax consultation process, are also implemented. Accordingly, unless there is a move to a post tax basis of regulation, or alternatively an appropriate increase in the tax wedge within the pre tax calculation, there is considerable risk that the allowance provided will not be sufficient to cover expected tax liabilities.

In determining the relative merits of a pre or post tax approach, the key overriding principle should be to ensure that the tax allowance provides companies with sufficient cash flow to cover their expected tax liabilities. We do not believe that moving to a post tax basis will adversely effect the incentive for companies to manage their tax liabilities efficiently and experience within the water industry, where a post tax basis is adopted, supports this view. Additionally, given that the impact of the taxation changes will have different impacts on each of the DNO's, the future projected effective tax rates of the distribution network operators will vary on a company by company basis. Where this is the case, we agree that it is not appropriate to adopt a pre tax basis for calculating tax allowances.

(ii) Incurred fixed costs of debt

An embedded debt allowance was made by Ofgem at DPCR99, in recognition of 'falling bond yields and lower expectations of inflation', which meant that 'estimates for the cost of debt based on present market rates may not allow companies to meet in full the cost of fixed rate debt taken out between 1995/6 and 1997/8'.

Although a decline of a similar magnitude in risk-free rates and inflation expectations has not occurred, the overall level of interest rates, and the term structure, has changed over the control period. We would welcome further discussions with Ofgem on this subject so as to ensure that the cost of capital includes an appropriate company specific adjustment in order to fund interest payments on efficiently incurred borrowings.

In determining the cost of capital, it is also important that Ofgem considers other issues that were not present at the last review such as Distributed Generation and the increase in Output regulation. Both of these issues require clarification within the regulatory framework and/or increases in the cost of capital.

### (c) Depreciation

Pre-Vesting assets for Aquila will be fully depreciated in December 2005, leading to a sharp reduction in depreciation charges and hence allowed revenue. The depreciation cliff face will therefore create material funding issues, which are exacerbated if there are increases in capital expenditure to improve network resilience, and meet social and environmental obligations such as Distributed Generation.

The cashflow problem caused by the depreciation cliff face largely manifests itself across DPCR 4. In our view this should be addressed by policies that bridge the financing gap without simply deferring the problem to a later date.

Where this impacted for some companies in DPCR 3, depreciation charges were advanced through a shortening of the asset life, from 33 to 20 years. However our analysis shows that whilst the cashflow position improves in the short term, the regulatory asset base almost halves in value, compared with the maintenance of a 33 year asset life. This is a major driver in reducing future regulated revenue relative to that projected under the current depreciation regime, and may precipitate future funding problems.

An alternative approach is to adopt pay-as-go for a proportion of capital expenditure, whilst retaining the current 33 year asset life for the remainder so that regulatory and statutory depreciation remain closely aligned. It is important that there are strong incentives in place for spending capex efficiently and hence for outperformance to be appropriately rewarded, if pay-as-go is introduced in any form. Whilst this could also address the funding issue in the short term, the RAB and hence returns earned will still continue to decline relative to total expenditure over the medium term. Therefore similar problems to those identified from tilting the depreciation rates arise.

As any proposals emerge from Ofgem to address this issue, financial analysis extending beyond DPCR4 should be undertaken to examine the potential for any future funding gap. Accelerated depreciation may form part of the solution, but the test of a policy's effectiveness is on whether companies are able to maintain cashflows consistent with an investment grade credit rating over the medium term. An over-reliance on any one proposal may simply store up future funding problems, necessitating a combination of practicable solutions.

### (d) Pensions

We are pleased that Ofgem considers pension costs to be an important issue at the next distribution review. At the time of the last price control, our main pension funds were in surplus and the Distribution business was experiencing a pension

holiday. The benefit of this was passed through to customers since it is our belief that operating cost allowances were set on this basis. The surplus has been carefully managed and the benefits from it appropriately shared.

There are a number of reasons why pension schemes are now showing deficits. In 1997, the Treasury ended dividend tax relief for pension funds, which are heavily invested in equities. Increased life expectancy has meant longer pension payments and hence higher costs for companies. The FTSE has declined from its peak of 6930 in the last trading day in 1999 to below 4000 in April 2003. Consequently, three years of negative equity investment returns has further exposed pension funds.

Due to the expected reduced investment returns in the future and improved pensioner life expectancy, we anticipate a substantial increase in the employer contribution rate. At the same time, the 1989 Electricity Act places obligations on Aquila to retain the same benefits for employees who were in our pension scheme up to Vesting.

The pensions issue will therefore affect cashflow, and hence the credit status of distributors. Without customers funding the burden of boosting the value of pension funds, distributors may not be able to retain an investment grade credit rating.

***“Other issues that will need to be considered as part of the price control review”***

The metering market is increasingly becoming competitive in nature. We have been working with the industry in developing appropriate regulatory arrangements to accommodate this. Fundamentally, DNOs should not be exposed to the risk of costs becoming stranded. Existing meter assets must either be left in the RAV, effectively restricting competition to new meters, or be assessed at a market value. The former will minimise the cost to the end customer by avoiding premature replacement whilst avoiding the need to undertake a complex valuation, and must therefore be given serious consideration by Ofgem.