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Adrianne Monroe
Manager – Price Control Development
Ofgem
9 Millbank
London
SW1P 3GE

Regulatory Affairs
98 Aketon Road
Castleford
WF10 5DS
www.yedl.com

tel (01977) 605738
fax (01977 605811
e-mail :kirsty.mchugh@yedl.com

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Dear Adrianne

DEVELOPING NETWORK MONOPOLY PRICE CONTROLS

UPDATE DOCUMENT – FEBRUARY 2003

Thank you for the opportunity to respond to Ofgem's latest update document on developing network monopoly price controls and on the open letter of 13 March 2003, which included the Frontier Economics reports for Workstream A and Workstream B and a draft timetable for the price control review of the distribution network operators (DNOs). I am writing on behalf of Northern Electric Distribution Limited (NEDL) and Yorkshire Electricity Distribution plc (YEDL).

We have previously indicated our support for the rationale and objectives for the current work on developing network monopoly price controls. Similarly, the objectives for the distribution price control review have been thoroughly debated.

Overall, we believe that the consultation document and the work of Frontier Economics have taken the debate forward in a number of important areas, particularly with respect to efficiency incentives and financial issues. The public workshop on the issues raised by the consultation was well-attended and the debate, particularly the afternoon discussion sessions, informative of the differing views of the various stakeholders represented. The workshop associated with the Frontier Economics reports was also useful.

The response from NEDL and YEDL is set out in the attached papers.

We would welcome the opportunity to discuss some of the points raised in this response over the next few weeks and shall contact you to make arrangements. In the meantime, if you have any questions or comments, please do not hesitate to contact me.

Yours sincerely

KIRSTY McHUGH
Director Regulatory Affairs

NEDL

YEDL

DEVELOPING NETWORK MONOPOLY PRICE CONTROLS UPDATE

DOCUMENT – FEBRUARY 2003

The response from Northern Electric Distribution Ltd
and Yorkshire Electricity Distribution plc

Response from Northern Electric Distribution Ltd

and Yorkshire Electricity Distribution plc

NEDL

YEDL

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INTRODUCTION

This response sets out the views of Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL) in response to the key issues raised in Ofgem's *Developing network monopoly price controls: Update document* (February 2003) and the reports published by Frontier Economics entitled *Regulatory Mechanisms for dealing with uncertainty* and *Balancing incentives*. A comprehensive response to all the issues raised by the *Update* is provided at Appendix 1 and detailed comments on the Frontier Economics reports are provided at Appendix 2.

RATIONALE AND OBJECTIVES

We agree with Ofgem that it is important to review the regulatory framework to introduce further improvements:

- to protect the interests of customers;
- to ensure that regulated companies have appropriate incentives;
- to take account of the government's security of supply, social and environmental objectives; and
- to improve the transparency and understanding of the process and, where appropriate, to improve consistency across different sectors.

ASSESSING COSTS AND INCENTIVES FOR EFFICIENCY

Use of benchmarking and distortion of incentives between operating and capital expenditure

We support Ofgem's view that a mechanistic use of regression analysis should not be used to determine allowed income at this review and believe that allowed income should be grounded in the reality of each company's observed costs. This will require a greater focus at the review on understanding both historic and forecast costs and an increased onus on companies to demonstrate the reasonableness of these.

In principle total cost approaches ought to be superior to separate analysis of operating and capital costs. However, the development of a model that appropriately captures the capital cost element and that introduces quality into the equation is probably some way off.

We have significant concerns regarding reliance upon benchmarking and yardstick approaches in price control reviews. The problems surrounding comparability, including model specification and cost allocation, and the introduction of quality into the assessment are well-known and remain to be resolved before benchmarking or yardstick methods can be used to determine the efficient costs of each company.

A further problem, which has attracted less attention to date but which was widely acknowledged at the workshop, is that the regulator needs to be satisfied that the companies whose costs are determining the yardstick or benchmark have adopted a reasonable position with respect to risk. Otherwise yardstick or benchmark methods can have the unintended effect of driving companies towards the position taken by the least risk-averse company. The Asset Risk Management (ARM) and Medium Term Performance (MTP) work has not sought to *determine* the appropriate risk profile for network companies to adopt and we do not believe that Ofgem wishes to make such judgements in place of the companies. If such judgements are to be left to companies, Ofgem should take care to ensure that a willingness on the part of some companies to take on risk above that which is implicit in the allowed cost of capital does not lead to a systematic, but unintended, pressure on all companies to take on greater risk. This is

especially important given the asymmetry of customers' likely preferences as between lower costs and security of supply.

One way to avoid this problem would be to determine each company's allowed costs by reference to the rolling average of its costs in the previous ten years. This would resolve periodicity problems and would ensure that incentives to efficiency were strong but grounded in the reality of each business. The danger of a company targeting higher returns and taking on additional risk by being overly aggressive in its cost cutting would be confined to that company (as would the consequences of failure) and would not infect the determination of other, more responsible, companies' allowed costs. If this approach was thought to give companies insufficiently stretching targets (given the cost reductions achieved since privatisation) the costs of the early years of the first ten years of the yardstick could be prescribed by Ofgem as part of the review and could be informed by responsible use of comparative analysis. Comparative analysis could also be used periodically to indicate any companies whose performance has diverged significantly from that of the sector. This might indicate that further investigation or action might be needed with respect to such companies.

If, nevertheless, Ofgem remains convinced that yardstick or benchmarking methods have a part to play then, as Frontier Economics suggested at the workshop, confidence can be restored to some extent by the use of average, rather than lowest, cost models.

Assessment of Capital Expenditure

The treatment of capital investment requirements within the price control review framework should aim to promote some clear and simple virtues. We propose that four main principles should be reflected, namely:

- to reinforce responsibility;
- to ensure sustainability;
- to increase efficiency; and
- to build credibility.

With this in mind Ofgem should focus on seeking out investment plans from companies that address a range of outcomes. These *outcomes* would be expressed quantitatively and would capture the benefits for customers that would result from the investment

plan (or range of plans). These plans would specify the *outputs* (i.e. the assets needed) that the plan envisages being delivered to secure these outcomes. Companies should be required to declare the investment in monetary terms that they expect to make to deliver the outputs that will secure these outcomes.

It is important that efficiency gains in both concept engineering and in engineering execution (i.e. both outcome - and output-related efficiency) should be encouraged and it will be necessary for Ofgem to promote a more open discussion with companies at the outset about where the companies will be looking for efficiency gains in the delivery of the defined outcomes. A more open and thorough debate that recognised the possibilities of future efficiencies at this stage of the review process would help to remove some of the problems of forecasting credibility that have been associated with capital investment at previous reviews.

Efficiency Targets

Ofgem mention, under ***analysis of market data***, economy-wide productivity trends as one possible benchmark for assessing the future level of costs. In this connection it is important to note that the Competition Commission and Ofwat have each acknowledged that the RPI component of the RPI-X price control already captures the productivity gains of the economy as a whole and thus the scope for efficiency targets factored into a price control review should be limited to those that may be expected from the company that are *in excess* of the productivity gains that may be expected from the economy as a whole. We would welcome Ofgem's confirmation that it shares this understanding.

There is considerable economic literature which corroborates the point that, in times of low inflation, it is more difficult for firms to outperform the RPI index.[1] We are currently in a period of sustained low inflation and this is likely to be true of the next price control period. This factor should be taken into account when assessing future cost levels, resulting in a less aggressive profile of efficiency targets.

[1] This is principally to do with inelasticities in the labour markets and is one reason why central banks do not aim at a zero inflation target. Inflation at modest levels assists the economy in securing labour productivity gains.

Incentives for outperformance

The continuing development of incentives for outperformance is an important element in the evolution of the price control framework to deliver long term benefits to customers. We believe that it is vital to retain and strengthen incentives for outperformance in both operating and capital expenditure and that companies achieving higher rates of return as a result should be regarded as a success of regulation, provided that quality of supply and network integrity are maintained. The introduction of rolling incentives will address periodicity issues and provide stronger incentives to pursue the diminishing efficiency opportunities that remain.

Power of incentives

It is important that regulation should both protect the interests of customers and provide companies with incentives towards efficiency. Economic theory indicates that the optimal share of efficiency savings between customers and companies is 50/50 where there is a linear relationship between cost reduction and incentives (the retained share).[2]

In the past when efficiency savings have been easier to identify and to secure it would not have been necessary or prudent for Ofgem to move to this optimal level. However, efficiency savings are now becoming harder to identify and to deliver and, thus, increasing the company share towards the optimal level is justified and is unlikely to lead to companies making profits that are difficult to justify or that will cast doubt on the effectiveness of the regulatory regime. This leads to the conclusion that a rolling period of more than five years is appropriate (since retention for five years delivers only a 29 per cent share for the company of operating cost efficiencies and an 11 per cent share for capital expenditure efficiencies). Additionally, innovators in competitive markets would generally retain a far greater share than is retained under five year price caps.

We believe that the power of incentives in relation to operating and capital costs needs to be reviewed because, currently, the capital efficiency incentives remain much weaker than the operating cost incentives. Clearly, the management of long-lived distribution assets involves a number of significant trade-offs between capital and

[2] It should be noted that even at this optimal level companies will not retain a 50 per cent share since the company share is pre-tax.

operating expense. Therefore we consider it important that incentives in these two expenditure categories should be in balance to ensure that, over the long-term, companies are provided with an appropriate, and balanced, set of incentives to ensure that outcomes are maintained at the desired level and at the long-run optimal cost. If this balance is not reached then there is a danger that initiatives that bring benefit in the long-term will be disregarded in favour of less valuable improvements (in overall terms).

The power of the incentive scheme will be driven by a number of factors: the length of the retention period, the proportion of the savings retained, the different treatment of operating and capital expenditure and the way in which efficiency is assessed. There is no reason why the retention period should be limited to the price control period or correspond between operating and capital costs.

Rolling opex

We welcome the introduction of a rolling opex incentive mechanism from 2003/04. As discussed above, the power of the incentive scheme will be dependent on the approach to assessing costs (whether this is based on a yardstick or benchmark approach or by reference to a rolling average of each company's costs over a specified period) and the retention period.

Commitment to rolling RAV

The Final Proposals for the last price control review (DPCR3) made a 'commitment' to introduce a rolling regulatory asset value (RAV) mechanism to reduce the perverse incentives under the previous methodology. The commitment made by Ofgem at that price control review was to adjust asset values in the next price control review by actual, rather than projected, spending on a rolling basis after the lapse of a five year period. This commitment was conditional on 'PESs meeting their *obligations* with respect to security and quality of supply' (emphasis added).

The IIP targets are not obligations in any sense. They are simply targets and failure to meet those targets carries its own financial penalties. There is no obligation on the part of the licensee to meet them. By contrast there are numerous obligations set out in the

statute, in regulations made under the statute and in the licence. We would also observe that it would be perverse to penalise companies in respect of genuine capital efficiencies that may have absolutely nothing to do with whether or not the companies meet their IIP targets.

The credibility of incentives depends crucially upon regulators honouring commitments given at price control reviews and the importance of this particular commitment is such that it should not now be varied by introducing a new condition that companies meet their IIP targets.

Treatment of deferred expenditure

We believe that the form of the price control should be based on the principle of incentivising companies to seek out all efficiencies to deliver an optimum cost / performance balance where performance is measured by outputs including network performance, safety and risk management. These efficiencies include the ability to extend asset lives due to advances in risk management and increased knowledge of the condition of the asset base in addition to productivity efficiencies which are seen in the form of reduced unit costs.

Deferred expenditure should therefore be accepted by Ofgem as a genuine and important means of achieving capital efficiency for the delivery of long term value to customers provided that a company has behaved responsibly and has met its statutory and licence obligations. The longer asset lives implied by the deferred expenditure may be expected to be reflected in the assessment of expenditure for the forthcoming period, not only for the company in question, but, if the efficiency could be applied in other companies, for the sector as a whole. By this mechanism Ofgem is able to maintain efficiency incentives and to pass the revealed benefits on to customers. Penalising the efficiency benefits of deferred expenditure, or distinguishing it in any way from other investment efficiencies, is likely to incentivise inefficient investment decisions and to cut off the flow of information about truly efficient cost levels on which incentive-based regulation depends to secure gains for customers. Ofgem has a number of tools at its disposal to satisfy itself that companies are delivering appropriate outcomes including MTP and ARM.

This point is reinforced by consideration of the undesirable attributes of the alternative. If Ofgem were to remove some, or all, of the benefits that accrue to companies from improving their understanding of their future requirements, or innovating in terms of how they operate and service their assets, or radically changing the way that they deliver functionality, then the companies would have a very clear incentive to stick rigidly to whatever construction plan was submitted to the regulator at the time of the price control review. There is a well-established rule of thumb in asset management that the value that is generated in the concept phase is of the order of five times that which is available in the procurement and operating phase of the life of an asset. An inflexible approach that fails properly to reward concept engineering efficiency gains would signal the end of incentives for this crucial element of efficient capital investment. We consider that our proposal for clear investment plans, with appropriate accountability from the licensee to the regulator would provide controls and would also encourage proper, cost-effective asset provision in the long-term.

Mechanism for rolling RAV

We believe that the rolling RAV mechanism should meet the commitment given at DPCR3 and should provide incentives with respect to capital expenditure that are appropriately balanced with incentives on operating expenditure. These principles would be achieved by replicating the pre-DPCR3 capital expenditure incentive (i.e. the retention of both the rate of return and the depreciation benefits) but extending the retention period appropriately to achieve this balance.

FINANCIAL ISSUES

Cost of capital

We welcome Ofgem's early debate on cost of capital issues and the work undertaken by Smithers and Co on behalf of the UK regulators. The Smithers report provides an understanding of why regulators, faced with the same point estimates may arrive at different cost of capital values based on whether the regulator is most concerned about prices or investment. We would suggest that at the first three price control reviews Ofgem's concern has been primarily about prices and the time is now right to move the focus towards investment and quality and security of supply. Indeed, depending on the

levels of investment associated with quality and security of supply and distributed generation, new finance may well be required in the next price review period. In these circumstances it is important to set the cost of capital towards the upper range of the point estimates. The Civil Aviation Authority (CAA), in the review of airport price controls, emphasised this point in February 2002 by stating that '*with investment being a priority, it is preferable to set the cost of capital too high rather than too low given the downside risk'.* The point has also been endorsed by the Competition Commission.

The Electricity Association has sponsored some research on cost of capital by OXERA. The report will be submitted by the Electricity Association as part of their submission to the consultation. We are generally supportive of the report and believe that a base weighted average cost of capital (WACC) towards the top end of the range is appropriate. In addition, we would comment on the following specific points:

- ***Gearing*** – we concur with OXERA and Ofgem that the level of gearing should provide companies with sufficient flexibility to respond to demands placed upon them and support the view that the level of gearing assumed in the cost of capital calculation for all companies should be set at 50 per cent in line with the assumption at the last review.

- ***Taxation*** – the price control should be based on the principle of enabling companies to fund their efficiently incurred tax liabilities. We believe that the introduction of Tax Bulletin 53 (with respect to non-load-related expenditure) and changes suggested under the Reform of Corporation Tax (with respect to depreciation) will mean that this principle is best met through a company specific post-tax approach.

- ***Incurred fixed cost of debt*** – we note Ofgem's comments and welcome the opportunity to discuss our financing policies. We believe that all the debt that is held in the UK group of companies that includes NEDL and YEDL was economically incurred in moving to an efficient financial structure. The decisions made represented a prudent view and achieved a balanced portfolio of fixed and variable debt over the life of the assets. Accordingly, we consider that an appropriate company specific adjustment to reflect this should be made in the cost of capital calculations.

THE NEXT DNO PRICE CONTROL REVIEW

Regulatory risk

We do not accept that distribution network operators (DNOs) have a risk profile that is markedly, or even at all, lower than that of the market as a whole. The lower risk characteristics that arise from the monopoly nature of some of the activities of a DNO are offset by the unique risks that apply only to price-regulated companies. The output prices of DNOs are largely fixed for the duration of the control. In this respect there is a level of risk that is higher than in competitive markets where industry wide shocks (e.g. oil prices) can be reflected quickly in changes in output prices. An approach which more closely reflected the characteristics of competitive markets would make greater use of automatic pass through provisions in relation to exogenous cost shocks. The alternative is to reflect this risk through an increase in the cost of capital.

Additionally, strong reliance on yardstick and benchmark approaches would increase overall risk for companies and increase the cost of capital since it is false to assume that equity or debt holders can diversify against this risk.

Mechanisms for dealing with uncertainty

We support the principle of the development of an overall framework to assist in determining the best regulatory response to uncertainty. The Frontier Economics work, which sets out a high level framework of decision trees to determine the best regulatory response to uncertainty, is a useful contribution to this debate.

However, there are currently no formal mechanisms whereby companies can be remunerated at, or before, the next price control review for costs of additional obligations (or changes to existing obligations) not known or identifiable at the time of the previous price review. Such ‘cost shocks’ could be passed through without weakening incentives to reduce costs, provided some observable measure for the costs in question is available. We believe that Ofgem should consult on the potential for more formal mechanisms to be codified and then incorporated into an appropriate licence modification.

Distributed generation

We have responded to Callum McCarthy and Cemil Altin in relation to the open letter to Chief Executives on distributed generation (DG) and since then we have met with Richard Ramsay and John Scott and presented a paper (jointly written with OXERA) on incentives for DG. We would welcome further discussion with Ofgem on the proposals put forward in this paper, and we remain keen to contribute to the continuing debate on DG . We believe the two key elements of an appropriate incentive scheme are:

- ***a higher rate of return on investment in 'used and useful' network assets to facilitate DG***. The problem some have identified with this solution is that of labelling the investment. A solution to this would be a requirement to pre-register work with Ofgem in order to earn the chance of a higher return. Pre-registration could also ensure that a higher return is not available unless a company also subjects itself to the risk of a lower return. This downside risk could be limited to the rate of return on other network assets provided the investment was used and useful for load; and

- ***a MWh revenue driver based on network capacity availability***. In principle DNOs should be incentivised to facilitate DG output. We believe that the best measure of the DNO's performance is the MWh that the network is capable of transporting from DG rather than the total MWh generated by DG which will be affected by many other extraneous factors that impact on the generator but are beyond the control of the DNO.

Pensions

In determining the efficient level of pension costs, and comparing this to the competitive environment, due regard will have to be taken of the 80 per cent of our employees who are members of the Electricity Supply Pension Scheme (ESPS) some 90 per cent of whom are 'protected persons' under the terms of the Electricity Act 1989. The Northern Electric scheme was effectively closed to new members in 1997 and only the existing ESPS members of YEDL and Yorkshire Electricity Distribution Services Ltd (YEDSL) were able to join the Northern Electric scheme on the acquisition of these companies in 2001. Other staff are members of defined contribution schemes or other private pension plans.

Within these constraints, the group seeks to minimise the overall pension costs of the business, as it does all costs of employment. The constraints of ESPS mean that the companies have less flexibility on pension matters for staff covered by those arrangements.

The Northern Electric ESPS scheme is a separate trustee-administered fund which adopts a prudent investment strategy designed to minimise pension contributions over the long term assuming normal market conditions.

The scheme is expected to face a deficit at its next actuarial valuation. This probable deficit does not arise from any imprudent act on the part of the companies with respect to the use of surpluses. It arises from the decline in the equity market and reducing bond yields. As well as providing benefits to members, previous surpluses have also been used to help to fund the costs of previous staff restructuring. Customers have thereby been able to benefit from the resultant savings in operating and capital costs without having to fund the costs of achieving those savings. In addressing the expected deficit position we will follow appropriate actuarial advice and the course of action will be agreed with the trustees. The resultant costs should be allowed in setting the next price control.

Quality / IIP

The funding of the capital expenditure necessary to enable the licensee to meet its duties is a fundamental task for the review. The bulk of revenue should remain within the RPI-X form of the control with additional elements being added to the price control formula to focus on outcomes and to deal with uncertainty.

The Information and Incentive Project (IIP) scheme should continue to reflect marginal penalties and rewards around the trajectory to an outcome that is desirable and consistent with the assumptions on which the price control is set. It should be symmetrical and we believe that the financial amount currently at risk is about right. Any move towards a relative scheme should be dependent on adequate normalisation, which we believe is some way off, and should apply only to target setting. Target setting is an area that will need to be reviewed following the completion of the rebasing

exercises and should be based on actual performance over the remaining years of the existing IIP scheme. It will also be necessary to take account of the costs of any targeted improvements.

Draft timetable for the DNO price control review

We welcome the draft timetable for the DNO price control review set out by Ofgem which, once finalised, will provide all parties with clarity over the review timetable and a firm foundation for resource planning. We support the high level comments provided by the Electricity Association Price Control Group on possible ways to improve the timetable by recognising the interactions between the policy issues, the data gathering work and the work on setting the control (developing detailed Po and X proposals).

WAY FORWARD

Our detailed comments on all of the issues raised in the consultation paper and the Frontier Economics reports are attached as appendices to this paper.

We would welcome the opportunity to discuss with Ofgem our detailed thoughts in a number of areas on a bilateral basis in the near future. It is helpful that Ofgem has identified the workstream leaders for most of the areas for consideration in the DNO review and we note that responsibility for the remaining areas is to be allocated in the near future.