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14 April 2003

Dear Adrienne

**Open Letter to DNOs on the draft timetable for the DNO price control review:
and work undertaken by Frontier Economics.**

You have invited comments on the Open letter on the above dated 13 March, and I am pleased to give our response below.

The Open Letter attached Ofgem's draft timetable for the forthcoming Distribution price control review. Mike Boxall as Chair of the EA Price Control Group has responded on behalf of the DNOs. We endorse the comments made in his letter and therefore have not gone into detail in this response. However, we would emphasise three of the points made in Mike's letter:

- We believe that Ofgem needs to decide at an early stage how DNOs should behave i.e. the outputs that DNOs are expected to deliver, in order that the forecast information request can be as focused and relevant as possible;
- With regard to Total Cost Modelling we would go further than other DNOs and say that we are firmly opposed to it being used to set price controls on the basis that it is arbitrary and is likely to distort investment decisions; and,
- In order to benefit from the work that has been done to date in the Working Groups and Workshops, then Ofgem should be considering on which topics early closure of discussions may be possible e.g. accelerated depreciation, the "rolling capex" methodology, use of a post-tax cost of capital and protection from stranded metering assets.

With regard to the Reports produced by Frontier Economics, we have included much of our comment in our response to the February Update document. However, we will be responding specifically to the Frontier reports in the next few days.

I hope that you find our comments helpful. We would be pleased to discuss any of the views expressed. In the meantime we look forward to continuing to play an active and constructive part in the ongoing work on the price control review.

Yours sincerely

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30 April 2003

Dear Adrienne

Work undertaken by Frontier Economics.

In Ofgem's Open Letter of 13 March, you have invited comments on the two reports produced by Frontier Economics. We have commented in some detail on incentives in our response to Ofgem's February 2003 Update Document. For ease of reference we have copied the relevant extracts in this response. We have also added more detailed comments on Workstream A – Regulatory Mechanisms for Uncertainty.

We welcome Ofgem publishing these reports. Our comments in summary are as follows:

- We are firmly opposed to the application of Total Cost Modelling (TCM) in setting the price control. In short, we believe that the TCM approach would be arbitrary and would undermine incentives to invest in the network;
- It is our concern that Ofgem may believe they have “solved” opex incentives by increasing the rewards available to the inefficient companies, through the “glidepath” and “rolling opex” methodologies. However, it is vital also to reward equitably the frontier companies, who have already achieved the savings (it should be recognised that it is the moving forward of the frontier that has enabled Ofgem to set the targets for the inefficient companies).

For these reasons it remains our firmly held view that the “average costs” methodology for certain opex allowances represents the strongest and most equitable incentive to efficiency. We believe therefore that the incentives put in place should in the end provide the same balance of rewards to the efficient and inefficient companies as would be available under an “average costs” methodology;

- There are significant upward pressures on both investment and operating costs which was not the case at the last price control review, and these will need to be fully reflected in Ofgem's proposals. Not only is it important to recognise the additional costs in DPR4 but it is desirable for companies to know in future how such costs will be recognised as they arise, without having to re-open the price control, if the DNOs are to continue to be regarded as low risk and low cost companies. To this end we welcome the work that has been going on in relation to Dealing with Uncertainty, although we have some questions and concerns which we have set out in the attachment.

I hope that you find our comments helpful. We would be pleased to discuss any of the views expressed. In the meantime we look forward to continuing to play an active and constructive part in the ongoing work on the price control review.

Yours sincerely

Rob McDonald
Group Regulation Manager

Workstream A - Dealing with uncertainty

It is important to recognise the many and significant upward pressures on DNOs costs, which have occurred since the previous price control. It is also desirable for companies to know in future how such costs will be recognised as they arise, without having to re-open the price control, if the DNOs are to continue to be regarded as low risk and low cost companies. To this end we welcome the work that has been going on in relation to Dealing with Uncertainty, and we have been pleased to play an active part in the Ofgem Working Group.

Frontier's work arrives at a decision-making framework, which overall we support, however it is important to note that few of the decisions in the decision trees are "black or white"; they require value judgements against the specified criteria. Ofgem would still need to ensure adequate consultation on each issue. It will also be desirable for Ofgem to set out the circumstances in which DNOs can request a cost adjustment using the appropriate mechanism.

More importantly, the mechanisms implemented must be simple and robust. Over-complication will reduce transparency.

The proposed decision making framework comprises eight criteria. We set out below our brief comments in relation to some of these:

- Materiality – it is not clear what is proposed where individual costs are not assessed as material but a number of such costs in aggregate would be material;
- Controllability – unit costs may be controllable. However, in aggregate this may not be the case as volumes may be uncertain;
- Diversifiability – it is necessary to be clear on how managers can diversify risk as opposed to how shareholders are able to.

Frontier hold that shareholders can diversify risk by holding a balanced portfolio of shares. In practice there are a number of limitations on this, for example:

- Not all ex-PESs are quoted;
- No distribution-only companies are quoted;
- Distribution businesses comprise many activities and it is not possible to diversify against everything.

In theory managers can diversify risk in some cases, for example through insurance. However, in practise it is difficult for managers or shareholders to diversify from risks arising as a result of future costs and regulatory uncertainty.

We do not believe that diversifiability is a practicable option in the decision-making framework. If the decision tree has led to this point there is no option in our view but an increase in the cost of capital.

In terms of the specific examples considered, we would agree that licence fees and NGC exit charges should continue to be subject to pass-through. For distributed generation, we have already responded to the regulatory issues raised in our response to the open letter to DNOs. However, in short we would favour a price control supplemented by £/MW and £/MWh terms for distributed generation.

Finally, in terms of IT-related change, we believe that any change to industry codes mid-price control (which tend to be approved by Ofgem) must take account of the cost of that change. We believe that this would be a mechanistic process (possibly administered by the relevant code body such as MRASCO or Elexon) and indeed should be a requirement for any change to the codes. This would allow Ofgem to assess efficient implementation costs and adjust price control allowed revenue accordingly (via, for example, a k-factor adjustment in the year the cost is incurred). As part of that process, we would agree that benchmarking of DNOs costs may be appropriate.

Workstream B - The existing framework of incentives applying to network monopoly companies

Comparing efficiency.

It is our firm belief that any “capex/opex trade-off” is overstated and therefore new and complicated methodologies and incentives are not justified or necessary. We note that the report makes no mention of the fact that at DPR3 incentives moved away from capex and towards opex, with the introduction of the glidepath or frontier methodology for opex and the “within range” adjustments for capex “inefficiencies”. This approach has made it much less attractive to invest in the network and hence removed any incentives to inappropriately substitute capex for opex. More fundamentally, their report does not quantify any “trade-off” but simply relies on a theoretical hypothesis that it must exist.

We also note that Frontier suggests that incentives on capex and opex are in fact aligned when comparing rewards for a one-off capex saving with an ongoing reduction in opex. The mismatch in incentives identified by Ofgem would occur when both capex and opex savings are perceived to be ongoing (rather than one-off), which is not necessarily the case.

Total Cost Modelling (TCM) is suggested as a technique to resolve this perceived and unquantified problem, and also any cost/ quality trade-off. We are firmly opposed to the application of TCM in setting the price control. In short, we believe that the TCM approach would be arbitrary and would undermine incentives to invest in the network. It is also not clear that TCM is necessary in addition to the proposed rolling opex and rolling capex methodologies, where incentives can be balanced by adjusting retention periods.

We also do not believe it is possible to develop a robust and agreed methodology, for example to define either Total Costs or the outputs which are delivered. It is therefore not at all clear that it brings any additional benefits over the current methodology for assessing efficiency and setting allowed revenue, which may have some flaws but at least the flaws are understood. We therefore believe that the broad approach to assessing opex and capex efficiency used at the previous review remains appropriate.

Crucially, we do not believe that TCM can be used to set allowed revenue until proved to deliver allowed revenues consistent with the current “building blocks” approach.

We have addressed our more detailed comments on Total Cost Modelling in Appendix 1.

Setting incentives.

- Opex.

We welcome the “rolling” retention of opex savings, although we have yet to see the detailed methodology proposed (for example how it will be applied to cost increases), and what definition of opex applies (e.g. does it include rates?).

However, we are very concerned that this gives higher allowances to those companies which are inefficient, and therefore starting from a higher cost base and have more opportunity to take out costs, than to those that have already achieved efficiency savings and consequently have lower costs. In addition, the efficient companies did not receive the additional benefits from the “rolling” methodology for those efficiencies made before this new methodology was introduced.

It also remains our view that the “glidepath” methodology, which was used in DPR3, already benefits the inefficient companies. In itself, it provides no incentive to be at the frontier. For example while inefficient companies only had to get 75% of the way to the frontier, and were given four years to get there, the frontier companies were given only 1% additional allowed revenue. This fell far short of the additional revenue (and potential additional profit) which the “laggards” were given. Indeed, we suspect that when opex efficiency is compared as part of this price control review, DNOs, which were judged as inefficient at DPR3, may still look inefficient on the expectation that they will again be given a glidepath.

It is our concern that Ofgem may believe they have ‘solved’ opex by increasing the rewards available to the inefficient companies. However, it is vital also to reward equitably the frontier companies, who have already achieved the savings. It must be remembered that it is the moving forward of the frontier which has enabled Ofgem to set the targets for the inefficient companies. Perversely, to add the “rolling opex” incentive to the “glidepath” methodology has the opposite effect, it represents a double hit for the frontier companies.

Ofgem’s aim in introducing the “rolling opex” methodology was to solve the perceived periodicity problem. However, periodicity is fundamentally caused when a company’s own costs determine its future allowed costs. It is therefore our view that some element of the periodicity problem will remain for as long as costs are based on own performance.

The strongest possible incentive for companies to continue to seek out operating efficiencies would come from using an external benchmark for operating costs, with savings against this benchmark retained by each company. An appropriate benchmark would be some form of average of peer group company costs. The incentive properties of such a mechanism are clear and in particular companies would have no incentive to delay making efficiencies, since doing so would have only a negligible impact on future allowances. An average cost approach would thus be effective regardless of where the industry finds itself in the cost reduction cycle. It is also worth noting that, while some companies at the frontier would earn higher returns, in aggregate the industry operating costs allowance would be

identical to the allowance under approaches which involve giving each company its own costs. For these reasons it remains our firmly held view that the “average costs” methodology represents the strongest and most equitable incentive to efficiency.

We believe therefore that the incentives put in place should in the end provide the same balance of rewards to the efficient and inefficient companies as would be available under an “average costs” methodology.

- Capex.

The RAV approach remains a strong incentive to investment, and we welcome the commitment to strengthen this through the “rolling RAV”, such that efficiency savings are retained for a fixed period. There are a number of ways in which this could be applied, some of which do not have the effect we believe is intended. We would welcome the chance to see Ofgem’s detailed proposals and model as soon as possible.

Crucial to the RAV approach is an appropriate cost of capital. We believe that 6.5% is, and has always been, too low. In the past DNOs have been able to boost returns by opex efficiencies. However, for the frontier companies there is no longer any significant scope for further efficiencies. Indeed there is considerable upward pressure on costs.

We would also be firmly opposed to any “within range” adjustments similar to those which were applied in DPR3. These were arbitrary and unforeseen and in our view do not represent good regulation. In particular, since these adjustments were not highlighted in advance they were in effect retrospective regulation which serves to undermine, not enhance, incentives.

Total Cost Modelling

Total Cost Modelling (TCM) was suggested at DPR3 as a possible solution to the perceived capex/ opex trade-off (i.e. the perception that DNOs are inappropriately incentivised to opt for a capex solution rather than an opex solution). It has also been suggested as a potential solution to any cost/ quality trade-off (i.e. the risk that companies will inappropriately reduce costs at the expense of quality).

We are firmly opposed to the application of TCM at the current price control review because we do not believe that a sufficient case has been made for a departure from the previous methodology. Indeed, we believe that TCM will damage incentives to invest in the current price control period and beyond. We also do not believe that it will be possible to develop a robust TCM methodology. We have set out each of these concerns in more detail below.

There Is No Justification For TCM

It is our firm belief that any “capex/opex trade-off” is overstated and therefore new and complicated methodologies and incentives are not justified or necessary. For example:

- regulatory accounting rules are being standardised, and therefore capitalisation policies should not differ materially;
- the opportunity for real substitution is de minimis anyway (some fault repair costs). We note that Ofgem did not find it necessary in most cases to make material adjustments at DPR3 (particularly in SSE’s case); and
- capex underspends in the past were not driven by opting for opex but by low returns, high risk and recovery of premiums paid for ownership of DNOs.

In addition, we note that the report produced by Frontier Economics makes no mention of the fact that at DPR3 incentives moved away from capex and towards opex, with the introduction of the glidepath or frontier methodology for opex and the “within range” adjustments for capex “inefficiencies”. Neither does their report quantify any “trade-off” but simply relies on a theoretical hypothesis that it must exist.

It is also not clear that TCM is necessary in addition to the proposed rolling opex and rolling capex methodologies, where incentives can be balanced by adjusting retention periods.

Against this background, we do not believe that Ofgem/Frontier Economics have put forward a sufficiently robust rationale for the substantial departure from the previous approach adopted at the last price review. In particular, we firmly believe that Ofgem should prove that any capex-opex trade-off is material before embarking on fundamental reforms of the process.

TCM Will Damage Incentives To Invest.

We are, however, very concerned that the application of a TCM approach (even in a supplementary role in “support” of other methodologies) would damage incentives to invest in the network. In particular, under TCM the RAV would in effect become meaningless. At present, DNOs will invest if they have certainty that such investments will be added to the RAV. To move from a RAV-based regime would be a major change, and we believe would actually have the opposite effect on incentives to invest and incentives to improve quality than intended (i.e. it would undermine incentives to invest) because the DNO would not earn a return on that investment.

This adverse incentive would be particularly apparent in respect of quality of supply expenditure. Indeed, we firmly believe that TCM would incentivise DNOs to avoid any quality of supply expenditure since there would be no benefit to them of incurring such costs. Another example would be expenditure designed to reduce losses on the system. As a consequence, any present bias under RPI-X regulation to defer otherwise efficient quality of supply investment would be exacerbated under a TCM approach. It is therefore perverse that quality of supply is being put forward as one of the arguments in support of TCM.

In addition, there is a real risk that the next price control could see DNOs subject to a complex web of inter-linked incentive schemes such as IIP, Guaranteed and Overall Standards, distributed generation and losses. In our view, TCM has the opposite effect than is intended by introducing these schemes (namely improvements in quality of supply). Putting this point aside, it will clearly be necessary to ensure that the aggregate effect of the numerous incentive schemes presently being considered by Ofgem is robust and produces the desired outcomes. We firmly believe that this task of ensuring overall consistency in the framework will be more difficult with the application of a complex TCM methodology that provides a very strong incentive not to invest.

TCM is Not a Proven Methodology

We do not believe that it is possible to develop a robust methodology for TCM in which affected parties could have sufficient confidence (even if only used in conjunction with other approaches).

Under a TCM approach standardisation of accounting rules would still be required, as would standardised asset lives and depreciation profiles. Otherwise, capital intensive companies may look more efficient in the short term. TCM therefore offers no advantages over the existing approach in terms of accounting simplicity.

By contrast, we believe that there would be significant issues raised by the definition of Total Costs adopted for comparative modelling. These problems are particularly acute in terms of the definition of the “capital” aspects of the production function. For example, if unadjusted recent capex is input into the model, the model will merely contrast companies that have invested in their network in the base year compared to those that have not, irrespective of whether that additional investment was efficiently incurred or not. Another alternative would be to use depreciation, but this would

similarly need to be adjusted to reflect genuine differences due to historical (efficient) past investments rather than inefficiency in the capital programme.

The scope of the necessary adjustments to determine a “normalised” capex/depreciation number is indicative of the scale of the problem. For example, adjustments to the base number would be required to reflect (at least) the following factors:

- Different customer numbers and length of networks;
- Differences in the split of vesting and post-vesting assets of DNOs in the base year;
- The use at the last price review of accelerated depreciation for some DNOs, but not others;
- “normalisation” for quality of supply to reflect differences in network performance, given underlying asset age, as well as geography and topography of the network;
- different rates of growth across DNOs and the impact of load-related expenditure;
- The point of each DNO in the historical investment cycle (age of assets will provide some clues on this, but cannot be relied on in isolation);
- Different degrees of investment to reduce losses on the network;
- The different degree to which individual DNOs have been subject to environmental obligations such as undergrounding;
- Differences in investment to connect distributed generation; and
- The effect of specific types of historic investment on individual networks (such as Consac cable).

We do not believe that it is credible to expect to adjust base year capex numbers to take account of all of these factors and produce a robust or meaningful “normalised” capital number for modelling purposes. Indeed, we firmly believe that any such “normalised” number would bear no relation to actual investment or depreciation and hence its application to assessing efficiency would be virtually arbitrary.

We are not aware of any other regulatory authority that has overcome these difficulties in a robust way. Indeed, we note that Frontier Economics approach in working with the Dutch electricity regulator was based on imputed values and took no account of the firm’s actual investment pattern, inflation and asset lives. It was therefore subjected to legal challenge.

Finally, it has also been suggested that TCM should additionally take account of the different rates of return across DNOs. This would be bizarre. RPI-X incentive

regulation is designed, by definition, to incentivise DNOs to improve efficiency and beat the base targets set by the regulator. By implication, this means that the efficient companies will earn a greater return. Hence, inclusion of the return in any TCM framework will benefit the inefficient.

Conclusions

It is not clear that TCM brings any additional benefits over the current methodology for assessing efficiency and setting allowed revenue, which may be flawed, but at least the flaws are understood. Neither is it clear that TCM is necessary in addressing capex / opex and cost / quality trade-offs, in addition to rolling capex, rolling opex and IIP methodologies.

We have also set out above why we believe a TCM methodology would damage incentives to invest and we have explained some of the practical difficulties in designing a robust total cost model.

For these reasons, we are firmly opposed to the application of TCM during the current price control review, even if it is used in conjunction with other methodologies. Given the complexity of this approach, we believe that exploring TCM models at this stage will involve substantial additional cost for Ofgem and companies for no discernible benefit to the review process.

We also believe that Ofgem's suggestion that TCM may be relevant in the review process could adversely influence DNOs behaviour in the current year, given the uncertainties about whether quality of supply investment will be rewarded under the price review. We would therefore ask Ofgem as a matter of some urgency to confirm that TCM will not be used at the current review. This would also allow a more focused application of Ofgem's own resources on the many substantial policy issues which need to be dealt with as part of the review.