JMF/SA

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Dear Cemil

DEVELOPING NETWORK MONOPOLY PRICE CONTROLS –
INITIAL CONCLUSIONS DOCUMENTS – JUNE 2003

CE Electric UK Funding Company (CE) is the UK parent company of Northern Electric Distribution Limited (NEDL) and Yorkshire Electricity Distribution plc (YEDL). The views expressed in the attachment to this letter represent the response of CE, NEDL and YEDL to Ofgem's publication of June 2003 *Developing network monopoly price controls: Initial conclusions.*

We are grateful for having the opportunity to comment on this document. In summary our views are:

- We support the principles for the regulatory framework set out by Ofgem. However, more serious thought needs to be given to the optimal share of efficiency gains as between customers and distribution network operators (DNOs). We believe that the share retained by the company should be increased to about two-thirds in order to maximise the benefit for customers.

- We suggest that one solution to the problems of periodicity and comparator-based assessments would be to base future income allowances on the rolling average of the costs actually incurred in the previous ten years.

- If non-operational capex is to be included in the regulatory asset value (RAV) it should be depreciated over a short life. Transitional allowances should be made to ensure equity between those companies that have already made such investments and those that have yet to do so.

- The framework for dealing with uncertainty proposed by Frontier Economics could be adopted by Ofgem as a policy commitment with respect to the treatment of future costs.

Yours sincerely

John M France
Director of Regulation

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CONTENTS

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INITIAL CONCLUSIONS– JUNE 2003

The response from CE Electric UK Funding Company (CE), Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL)

Ofgem's publication *Developing network monopoly price control – Initial conclusions,* June 2003, (the *Initial conclusions*). The *Initial conclusions* paper represents the culmination of the work carried out over the last twelve months, led by Ofgem with significant input from the industries that it regulates, with respect to the way in which network price controls might be improved.

In general terms we find ourselves in broad agreement with the principles and observations set out by Ofgem in the *Initial conclusions* publication and we are grateful to Ofgem for having given us the opportunity to contribute to this exercise ahead of the commencement of our own forthcoming price control reviews.

We shall not in this response recite all the areas where we agree with Ofgem's conclusions but shall focus our attention on those areas where we believe that further thought is required. Furthermore. since many of these are taken forward in more detail by Ofgem in the July 2003 publication E*lectricity Distribution Price Control Review: Initial consultation (68/03*) we shall, in this response, confine ourselves to a brief summary of our concerns and we shall develop these more fully in our response to the *Initial consultation*.

GENERAL PRINCIPLES FOR PRICE CONTROL REGULATION AND CONSISTENCY OF REGULATORY FRAMEWORKS

Although we support the principles for the regulatory framework outlined in the *Initial conclusions* publication we believe that more serious thought needs to be given to the optimal sharing of benefits between companies and customers. Customers will continue to benefit from efficiency gains only if companies are given the opportunity to out-perform the assumptions made at the setting of the price control. The purpose of regulation is to protect customers. Regulating the profitability of companies is necessary to achieve this purpose; it is not an end in itself. We believe that increasing the level of incentive on companies will lead to a greater level of efficiencies achieved and thus to increasing the benefits to customers.

ASSESSING COSTS AND INCENTIVES

Transparency and the range of efficiency indicators

We have in the past indicated our qualified support for Ofgem's intention to use a range of techniques for assessing the efficient level of costs. We remain of this view because we are concerned that reliance on any single method will expose us to significant risk of an unwarranted cost disallowance if the chosen method of assessment is insufficiently robust. The broader the range of methods used by Ofgem the greater the chance that major errors will be avoided by the balance of judgements made by Ofgem. But this use of judgement introduces a further problem with respect to incentives. Ofgem has stated (and we agree) that it is important that the methods used and the judgements made by Ofgem are transparent. It is easy to satisfy the requirement of transparency in the mechanistic application of a single statistical technique. It is rather harder to achieve complete transparency when the judgement that is made involves the balancing of a number of indicators (some of which may contradict or at least suggest different levels of relative efficiency). Nevertheless, increased transparency and an explicit recognition of the limitations of specific techniques would add to confidence in Ofgem's conclusions.

Incentives and recovery of entitlement in future periods

The problem of satisfying the requirement of transparency is made more challenging when a price control review is the process by which, not only is the regulator trying to determine the efficient level of costs (for which revenue allowance must be made for the forthcoming regulatory period), but also is the means by which out-performance, or cost recovery of unanticipated cost shocks, from the previous period are remunerated in the forthcoming period. Where regulators apply judgement, rather than mechanistic models (or even where they apply judgement in the choice of which statistical techniques to employ), there is no simple way that the regulatee can be certain that the judgement in respect of future allowed costs has not been influenced by the regulator's awareness of the additional income which the regulatee is to receive from the out-performance, or cost recovery, mechanisms that relate to performance or events in the prior period. This lack of certainty diminishes the incentive power of the mechanism.

If mechanisms such as the rolling RAV, rolling opex out-performance, and recovery of bad debts are to continue after 2005 because they have desirable incentive or other properties, the industry and Ofgem need to find ways to bolster the credibility of these mechanisms so that companies can have confidence that they really will receive the benefits and that they will not be, perhaps even unconsciously, reflected in harsher judgements about future efficient cost levels.

The risks of comparator based assessments

Before setting out our thoughts on a solution to this problem we must first consider a further potential problem with comparative methods of assessing efficiency. Although Ofgem has, in principle, recognised that lowest cost does not necessarily mean best, it is not clear how Ofgem intends to recognise this truism in carrying out efficiency comparisons. Failure to recognise the problem could have serious repercussions.

Consider the following scenario: Ofgem carries out a price control review and sets an allowed income that reflects a relatively low rate of return, commensurate with Ofgem's judgement that distribution is a low risk activity. Some companies then decide that they wish to target a higher return than that assumed by Ofgem. They do so by cutting costs and in so doing they take on more risk. The companies concerned may fully understand the extra risk that they have taken on (for instance, by extending maintenance periods) or they may not. Ofgem then carry out a price control review and find that these companies have the lowest costs and, at the point that the review is carried out, there is no evidence that they are failing in the performance of their duties. Ofgem concludes that all companies should be able to achieve similar cost levels and sets price controls accordingly. The other companies accept the price controls and follow the example of the 'frontier' companies. The result is that, in the sector as a whole, costs are lower, and risk of failure is higher, than before. At best there may now be a mismatch between the allowed cost of capital (if the regulator does not recognise the extra risk) and the true risk of the business. At worst there will be an unintended downward spiral as companies are forced to imitate not the most efficient, but the most reckless, of their peers in order to meet the regulator's assumptions. In order to meet the expectations of their shareholders or in anticipation of similar treatment at the next review, they may judge that they must cut costs yet further. So the downward trend continues and regulators understandably, but wrongly, conclude that there is further scope at the next review to turn the screw a little more. Indeed, some may even conclude that the lower cost levels achieved cast doubt on the integrity of the forecasts submitted by companies and this, in turn, adds to the regulator's determination to be even more sceptical about such forecasts at the next review.

The dangers inherent in the reliance on the comparative approach are obvious. They are compounded by the fact that the consequences of neglect, or the taking on of extra risk, are not apparent within the timescales of a price control review. It is interesting to note that one of the companies that represented the efficient frontier at the last price control review had difficulties in responding adequately to the storms of October 2002

The output measures and asset risk management (ARM) assessments may have a useful part to play in providing some reassurance to Ofgem but we do not believe that these have been developed to the point that is necessary to balance the clear dangers inherent in using comparative methods that rely on the use of frontier companies to determine the efficient costs of other companies.

So what can be done to establish powerful, yet virtuous, incentives that do not have the drawbacks identified above with respect to the credibility of incentives and the unintended, or irresponsible, introduction of risk?

The solution: the rolling opex allowance

We have suggested a solution to these problems that, so far, does not appear to have received full consideration from Ofgem. In this response we develop these thoughts. We recognise that for Ofgem to take up this suggestion would be a significant departure from previous policy, but we offer it once again for serious consideration. If Ofgem perceive drawbacks we should like to understand what these are. It may well be that, after consideration of Ofgem's objections we shall understand and we shall then cease to promote this solution.

We believe that one way to avoid problems of periodicity and to preserve responsible efficiency incentives would be to determine each company's allowed costs by reference to the rolling average of its own costs in the previous, say, 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 high 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 even 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.

The optimal retention period

This approach could be implemented in such a way as to capture the optimal retention period for efficiency savings. We recognise that, at the time of publication, Ofgem states that it could not see any theoretical justification for any extension of the period during which companies retain the benefits of their efficiency gains. Since then we have submitted an analysis that suggests that the power of the incentive mechanism to benefit customers is maximised if the share of benefits accruing to the company is increased to at least two thirds. We look forward to discussing this within the incentives working group.

The treatment of capex efficiencies

It is clearly right that Ofgem intends to allow companies the benefits of all capex efficiencies regardless of how they have been achieved. It would also be inappropriate for consumers to fund improvements in the network where performance has deteriorated as a result of *inefficient* under-investment in the network and the companies have benefited from the avoided cash flows.

Non-operational capex

We support the pragmatic proposals to reduce distortions between operational and non-operational expenditure by allowing all projected non-operational capital expenditure into the regulatory asset value (RAV) and to depreciate the capital expenditure over an appropriate period of time based on a generic asset life. The period would be shorter than for conventional distribution assets and should reflect a prudent view of the life of the asset category. There also needs to be recognition in the cost analysis that some DNOs will incur non-operational capex whilst others will incur the same cost in the form of bought in services from other providers. We support the proposals to incentivise efficiency in the same manner as that used for operational capex by allowing savings to be retained for a fixed period of time. We understand that under certain circumstances companies may wish to spend more than forecast if the investment will improve efficiency or network performance and we welcome Ofgem's commitment to assess such situations on a case by case basis.

Some transitional arrangements may be necessary to ensure equity between companies that have, efficiently, made investments in the past (which have hitherto not been added to the RAV) and may not have been fully allowed as an operating cost. Allowance must now be made for these past investments if these companies are not to be disadvantaged relative to the companies who are only now embarking on these investments. This is particularly appropriate in those case where the companies are still depreciating these investments in their accounts.

The framework for dealing with uncertainty

We support the principle of the development of an overall framework to assist in determining the best regulatory response to particular areas of 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 and we look forward to working with Ofgem to take this forward during the remainder of 2003. We are not sure that this could find formal expression as a licence condition. It could, however, be a 'policy commitment' published by Ofgem which might give some reassurance about the treatment of such costs.

Recovery of unforeseen costs

We also welcome Ofgem's recognition of the need to deal with unforeseen additional cost obligations appropriately. We have mentioned above the problems associated with any cost-recovery mechanism that straddles a price control review. 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 and companies can demonstrate that they have acted to manage the new costs efficiently. Up to now, such events have been dealt with on a case by case basis. However, we are of the opinion that the principle of transparency/predictability would be enhanced if such procedures were codified and then incorporated into an appropriate licence modification so that cost recovery did not depend on regulatory discretion at a forthcoming review.

INCENTIVES TO INVEST

Improving the assessment of investment needs at a price control review

The *Initial conclusions* publication accurately summarises (at paragraphs 3.52-3.55) the incentives that operate within the current approach to the treatment of capital investment at price control reviews. Ofgem then goes on to identify the potential drawbacks of this approach and the improvements that might be introduced.

There is merit in the proposition that Ofgem should gain a better understanding of how companies have prepared their capex forecasts. However, we have some reservations about some of the other suggestions being considered.

The *Initial conclusions* paper suggests that Ofgem may seek to identify and quantify investment drivers (or output measures) that can be incorporated within the arrangements to ensure that companies receive appropriate additional revenue. We agree that this may be appropriate and can see that it has the merit that it may reduce the extent to which Ofgem has to rely on forecasts of investment levels. However, the example cited of the iron gas mains replacement has the drawback that engineering concept gains are not rewarded. The only gains that are rewarded are reductions in unit costs. There may be circumstances where such a mechanism is appropriate but it would be wrong to introduce this approach where engineering concept gains have the potential to reveal efficiencies that, in due course, can be passed on to customers.

The *Initial conclusions* paper suggests that flexibility could be introduced so that the assumed capex is not seen as a maximum, but as base level which companies might exceed where there was proper justification. This needs careful thought. We do not believe that the principal reason why companies tend not to exceed the assumptions made at the setting of the price control has much to do with fear of disallowance. Rather it has to do with there being no compelling case to invest above the efficient level and because additional investment even if allowed into the RAV at the next review, would, under current arrangement, be wealth destroying for shareholders in the meantime. This is because marginal investment goes unremunerated until the next review and the revenues forgone during these 'missing years' are never recovered. It is hard to see how such a system could be introduced in a way that would allow companies to secure their cost of capital on the investment without at the same time compromising efficiency incentives. The present system has the merit of:

- discouraging unnecessary investment; and
- remunerating necessary investment (up to the level assumed at the review) at the assumed cost of capital.

The alternative approach under consideration would:

- (if the allowed cost of capital was set at, or above, the true cost of capital of the firm) encourage excessive investment; or
- (if the allowed cost of capital was set too low) discourage companies from making necessary investments.

It would also be necessary to consider the cash flow consequences of such an approach. It would be necessary to make provision for cash flows involved in the investment that are, under current arrangements, factored into the depreciation and return elements of the derivation of allowed income and are considered in the financial ratio analysis carried out by Ofgem. It would not be sensible to place companies in a position where they are encouraged to avoid prudent investment because the adverse cash flows would impact upon key financial ratios.

FINANCIAL ISSUES

Our views on the financial issues raised in the *Initial conclusions* publication are set out in our response to the *Initial consultation* publication and in a separate response on the treatment of pension liabilities that we shall be submitting to Ofgem.