Cemil Altin
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Office of Gas and Electricity Markets
9 Millbank
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Date: 22 August 2003

Dear Cemil

Developing network monopoly price controls: initial Conclusions: June 2003

Thank you for the opportunity to comment on the above paper. We are responding on behalf of EDF Energy. EDF Energy has significant interests in gas and electricity supply and electricity generation, and owns the three electricity distribution businesses serving London, East Anglia and the South of England:

EDF Energy Networks (LPN) plc (formally London Power Networks plc)
EDF Energy Networks (EPN) plc (formally EPN Distribution plc)
EDF Energy Networks (SPN) plc (formally Seeboard Power Networks plc)

Our responses to Ofgem's July price control papers on the distribution price control review, metering issues, and on innovation and Powerzones are made under separate cover. Those responses should be read alongside this one.

Our key points are:

<u>Assessing costs and incentives</u>

- Ofgem's commitment to use its uncertainty methodology at the time of a price control is welcome but insufficient. Occasional use leaves unsatisfactory levels of regulatory uncertainty between such reviews. Companies should have enforceable and appropriate cost recovery rights at any time.

- We note and welcome Ofgem's clarification in its July 2003 paper[1] that the start date of the five year capex incentive mechanism is 1 April 2000 in line with commitments made at the last review.

[1] Electricity distribution Price Control Review, Initial Consultation, Ofgem, 16 July 2003

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- Total cost modelling may provide a useful safeguard against the risk of unsustainably low cost allowances in respect of separate capex and opex allowances. Ofgem should attempt total cost assessments as a check on any other comparative analyses. However, Ofgem must carefully choose a definition of capital and operating costs that highlights differences in efficiency, not just accounting differences.

- We are surprised by the assertion that there is no theoretical justification for a 50/50 sharing rule and question whether Ofgem has carried out appropriate research into the relevant theory. For example, we are aware of a paper by NERA that examines, inter alia, the theory behind maximising consumers' welfare through incentive arrangements. We believe that the justification for other sharing rules is weaker.

- We agree broadly with Ofgem's further thoughts regarding the price control treatment of non-operational capex. However, Ofgem proposes to include non-operational capex overspends in the RAB where it deems the expenditure to be efficient on a case by case basis. To determine cost recovery ex post would lead to uncertainty and represent overly intrusive regulation, unless Ofgem sets out in advance clear criteria and procedures for disallowing such expenditure.

- We have itemised a number of unexpected costs that have arisen during the current control period for which we are expecting recovery in the next control period via the forthcoming price control review. Chief among these are Enron bad debts and lane rental charges (the London Borough of Camden trial). We shall be providing further information with our historic BPQ submission.

- Significant levels of asset replacement will be required over the next price control period, and well beyond. In this context, it is essential that Ofgem should agree investment levels with the companies, rather than impose its model on them. Failure to get this aspect of the price control right could have far reaching consequences for consumers. We are expecting, and are prepared for, an open and robust dialogue with Ofgem and its advisors in this area.

- If Ofgem remains uncertain about the level of future investment, the use of investment volume drivers can be useful where the unit costs are reasonably predictable. In the context of electricity distribution, cable and plant replacement programmes may be suitable areas for similar treatment, particularly if incentives were to provide for companies to outperform against the regulator's unit cost assumptions and thus achieve premium rates of return.

- We agree that there is presently no clarity about how capex overspends will be treated. Ofgem appears to be concerned about the risk of companies deliberately overspending. We believe that such behaviour is most unlikely. Ofgem should only, in our view, be concerned about such behaviour if there is evidence that it is occurring. Efficient overspends should attract the normal rate of return.

- Ofgem proposes that companies will retain the benefit of asset disposals or transfers out for five years, at which time a RAV deduction based on the proceeds will be made. An approach which shared any sale proceeds above the written down value for five years would provide stronger and more equitable incentives. Any new arrangements must not be applied retrospectively.

- Accelerated erosion of RABs would destabilise companies' finances and increase the cost of capital. We anticipate that this issue will be relevant and significant in the forthcoming distribution price control review because of the increasing investment needs. We will work closely with Ofgem in developing its financial modelling to find acceptable trade-offs between the short and long terms.

<u>Pension costs</u>

- To the extent that the assumptions used to forecast future conditions have fundamentally changed, reflecting the impact of uncertainties beyond the reasonable control of distributors, an increase in future contributions to pension funds funded by the price control is clearly justified by the principles of incentive regulation.

- We note Ofgem's initial view that its estimates of pension costs should be based on the next triennial actuarial valuation of the ESPS as at 31 March 2004, and that changes to the traditional timetable may be needed to achieve this. However, we do not believe that this is practicable, given the length of time needed to complete that valuation. It would also seem to be inappropriate (and in law it may be ultra vires) for scheme trustees to authorise changes to the timetable for extrinsic purposes.

- Ofgem states that, in carrying out previous reviews, it 'has not looked at pension costs and their funding in isolation' and adds that 'it will not be straightforward to establish what allowances for pension costs were implicit in earlier price controls'. We are therefore concerned at Ofgem's subsequent conclusion, seemingly reached on pragmatic grounds, that it might be appropriate to assume 'that the implicit annual allowance was equal to the efficient and attributable proportion of the company's recorded accounting charge based on headcounts and average unit payroll costs'.

- Prior to the legal separation of the supply and distribution businesses, the distribution business was purely an accounting and regulatory construct within a single legal entity (the public electricity supplier, or PES) created by statute. Liability for pension costs rested with the PES rather than with the specific regulated businesses.

- Statutory transfer schemes authorised by the Secretary of State have resulted in the distribution business successor carrying the cost of current pension obligations and of historic redundancy payments associated with employees who left in the past and whose activities would not now be classed as distribution activities.

- The cost of pension obligations caused by these past employees derives from statutory obligations that distributors cannot reduce or avoid, and that are not imposed on other companies. Ofgem should make allowance for recovering the cost of such obligations, since that cost is unavoidable.

- It would not have been appropriate to transfer such obligations to any competitive business unbundled from distribution. The actual size of the obligation would have depended on past levels of efficiency and past efficiency gains, and not on the efficiency with which the new supply business (for instance) was able to carry out its activities. Such businesses are now in competition with other businesses unencumbered with such obligations and so would be unable to recover the costs. More fundamentally, to have knowingly put the payment of such obligations at greater risk would have breached the statutory duties of fund trustees.

- While previous regulatory decisions have explicitly ruled out giving a revenue allowance for enhanced pension and redundancy payments, Ofgem's regulatory policy has (implicitly and in fact) been to allow revenues to cover payments into the fund. It would be inconsistent for Ofgem to change that policy now, just because payments into the fund represent a cost that is increasing.

- Since customers did not pay for the original redundancy payments, it cannot be argued that customers would be 'paying twice' if they are now to provide revenues to cover the cost of additional pension contributions. On the contrary, this would be the first opportunity that distributors have had to recover the cost of the investments they made to reduce their workforce.

- Ofgem's paper does not spell out how a distributor might have gamed the system (in Ofgem's terms) under the existing and/or previous distribution price controls. For such a charge to stick, however, Ofgem would have to be able to demonstrate on a case by case basis that:

- The distributor encouraged workers to leave the industry during the 1990s by making large redundancy payments out of the pension fund;
- The redundancy payments were ‘overly generous’, in that they exceeded a prudent estimate of the resulting cost saving to the pension fund; and
- The distributor expected Ofgem to react to this accumulating problem by raising future allowed revenues.

Our past behaviour does not meet these conditions and therefore Ofgem need have no concern about gaming in the pensions context.

We would welcome the opportunity to discuss our views with you. My assistant will be in touch to organise a date when we can meet.

Yours sincerely

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Paul Delamare
Head of Price Control

General principles for price control regulation and consistency of regulatory frameworks

General principles for price control regulation

Ofgem cites the use of pension fund surpluses to fund staff reductions as an example of ‘gaming the system’ (p2.70). We reject this assertion and explain our reasons for this in our comments on the Financial Issues section of Ofgem’s paper below.

Ofgem intends (p2.11) to produce a regulatory impact assessment (RIA) at the beginning of a price control project, additional RIAs for significant new or changed policies, and a final RIA covering the final proposals. We support this approach.

Ofgem’s commitment to use its uncertainty framework methodology (p2.13) at the time of a price control is welcome but insufficient. Occasional use at price control reviews leaves unsatisfactory levels of regulatory uncertainty between such reviews. Companies should have enforceable and appropriate cost recovery rights at any time. We expand our arguments in this area below.

Consistency of regulatory frameworks

Ofgem sees no justification in the material alignment of the distribution and transmission regulatory frameworks (p2.22). We agree with this conclusion for the reasons set out in our response to Ofgem’s February consultation.[2]

Replacement of shared GSP[3] assets

Ofgem will consider modifications to the regulatory framework to ensure that efficient decisions are made regarding the replacement of assets shared between distributors and NGC (p2.23). We welcome this and believe that in practice this means that Ofgem will need to determine any relevant dispute between a distributor and NGC. Our future BPQ will set out our investment plans, including the replacement of GSP assets and details of any material divergence from the work described in NGC’s current seven year statement.

Harmonisation of price control review dates

We agree that in the context of new GB-wide arrangements there should be alignment of the review date of the Scottish transmission price controls with that of the England/Wales review (p2.28). However, if BETTA is implemented in 2005 and alignment is 2006, a mini-review may be required for 2005.

[2] Developing Network monopoly price controls – Update document, Ofgem, February 2003
[3] Grid Supply Point

Alignment of the dates for the electricity transmission and gas transportation reviews would seem sensible because of the current shared ownership of these networks in England and Wales, and the growing interdependency in the generation of electricity and the availability of gas transmission capacity (and particularly landing capacity).

Assessing costs and incentives

Periodicity of incentives

We note and welcome Ofgem's clarification (p3.14) in its July 2003 paper[4] that the start date of the five year capex incentive mechanism is 1 April 2000 in line with commitments made at the last review.

We welcome Ofgem's recognition that deferment of investment (p3.15) can represent an efficient decision and that the company should be allowed to benefit from this (i.e. no retrospective adjustment to incentives will be made in this respect).

Ofgem's intention to allow companies to retain the benefits of both the depreciation allowance and the cost of capital for capex efficiencies now aligns with our legitimate expectations established at the last review. However, it is unfortunate that incentives rely on repeated statements of Ofgem's intention, rather than some firmer commitment. We believe that it would be beneficial for Ofgem to clarify all such incentives by setting out the specific accounting rules that will be used (in this review and in the next regulatory period) to define the incentive allowance. If possible, these rules should be incorporated into the RAGs, as memorandum items.

Distortion of incentives between opex and capex

Ofgem rightly notes that there are practical difficulties in robustly modelling cost efficiency on a total cost basis (p3.27) and that it intends to develop its thinking further on total cost modelling over the next few months. We believe that despite Ofgem's work in establishing draft regulatory accounting guidelines significant data comparability issues remain (particularly regarding capitalisation of costs and interpretation of activity definitions) and, as a result, the robust benchmarking of costs (whether 'bottom-up' activity costs or 'top-down' opex and capex costs) is not practicable. Total cost modelling may provide a useful safeguard against the risk of unsustainably low cost allowances in respect of separate capex and opex allowances. Ofgem should attempt total cost assessments as a check on any other comparative analyses, but Ofgem will have to use a definition of costs (particularly of capital costs) that measures

[4] Electricity distribution Price Control Review, Initial Consultation, Ofgem, 16 July 2003

real inputs to give some idea of current efficiency, rather than accounting costs which reflect past decisions and accounting policies.

Ofgem notes that it intends to improve the reporting of costs through the regulatory accounting guidelines (p3.28). Ofgem's initial consultation of improving regulatory accounts was in August 2000. It is most disappointing that, three years later, final regulatory accounting guidelines have not been published and that the relevant licence modifications have not been made. As a result, data from regulatory accounts cannot yet be regarded as comparable. Ofgem should ensure that its regulatory accounting work is brought to an appropriate conclusion in time for the 2003/04 accounts, and that the RAGs are updated for 2004/05 to cover any regulatory requirements (such as capex and opex incentive allowances).

Retention period for efficiency savings

Ofgem states (p3.34) that it 'does not see any theoretical justification to suggest that a 50:50 sharing rule between consumers and companies, for efficiency savings achieved under network monopoly price controls, would provide an appropriate balance between these two objectives'. We are surprised by this stance and question whether Ofgem has carried out appropriate research into the relevant theory. For example, we are aware of a paper by NERA[5] that examines, inter alia, the theory behind maximising consumers' welfare through incentive arrangements. We would expect Ofgem to at least review the literature before reaching its conclusion. However, there is no evidence in the consultation paper that this has been the case or that Ofgem has any justification for choosing a different sharing rule. We believe that the reasons for picking any other rule can only be weaker than those set out by NERA and that Ofgem should reconsider its stance.

Ofgem goes on (p3.36) to state that it sees no evidence that efficiency incentives need to be increased (or weakened). We comment as follows:

- Ofgem itself is concerned about perverse substitution of opex and capex (p3.18) and yet sees no need to balance incentives appropriately. Maximisation of consumers' welfare (and therefore the furtherance of Ofgem's principal statutory objective) will only be achieved if the share of efficiency gains passed to consumers is optimal.

- Savings are increasingly difficult and costly to find: consumers' welfare will not be maximised unless incentives are correspondingly strengthened.

From our comments above, it should be clear that we agree with Ofgem's conclusion that the issue of appropriate retention periods/proportions will need to be revisited at the next review.

[5] Incentives and Commitment in RPI-X Regulation, Topics 20, NERA

Treatment of non-operational capital expenditure.

We agree broadly with Ofgem's further thoughts regarding the price control treatment of non-operational capex. Our comments follow**:**

The effect on capitalisation may not place undue pressure on the financial position of companies as Ofgem believes (p3.43). However, this can only be assessed in the context of other capital commitments, many of which are expected to increase (e.g. for distributed generation, asset replacement, and network resilience). It would be sensible in our view to consider funding routes in the light of Ofgem's financial modelling and ratio testing.

Ofgem intends to allow companies to retain the benefits of any efficiency saving on non-operational capex for a fixed period of time. This seems sensible. The mechanism proposed by distributors in respect of operational capex ought to be a suitable model for a non-operational capex scheme.

Ofgem also proposes to include non-operational capex overspends in the RAB where it deems the expenditure to be efficient on a case by case basis. We agree that overspends should be included in the RAB**:** however, to determine cost recovery ex post would lead to uncertainty and represent overly intrusive regulation, particularly if DNOs are required to prove that their expenditure is 'efficient' by some undefined (and probably subjective) standard. We believe that Ofgem will only maintain incentives and avoid unnecessary risk by setting down objective criteria and procedures for disallowing expenditure that is demonstrably inefficient or imprudent. We do not therefore support this aspect of Ofgem's proposals, which we note has not been a feature of the regime applying to operational capital.

Regulatory depreciation periods should broadly align with accounting lives. A generic five year asset life seems appropriate.

Dealing with uncertainty

We itemised a number of unexpected costs that have arisen during the current control period for which we are expecting recovery in the next control period via the forthcoming review. Chief among these are**:**

- Enron bad debts
- Lane rental charges (the London Borough of Camden trial)

We will provide further information with our historic BPQ submission.

We continue to believe that Ofgem should put in place robust and enforceable mechanisms that give the appropriate level of regulatory certainty in respect of unanticipated cost shocks. Indeed, we explain below why this would be a necessary and essential adjunct to the financial ring fence, and why it would be consistent with Ofgem's requirement to have regard to the financing of licence holders' obligations.[6]

Ofgem notes (3.50) that the present system for dealing with uncertainty 'appears to have worked well'. We do not agree. The avoidance of problerms is due to a conjunction of broadly favourable circumstances, not to any features of the present system for dealing with uncertainty. The current system relies on ex post facto consideration by Ofgem and involves high levels of regulatory uncertainty. We can now anticipate a greater number of adverse scenarios (given the reduced scope for cost savings), so we believe that Ofgem needs to set out a more transparent system of managing uncertainty in advance.

Incentives to invest

Ofgem is correct to say that the risks in setting future levels of capex are asymmetrical. Clearly, the impact of network under-investment on consumers can be significantly greater (in terms of the effects on them of quality of supply degradation) than the impact on them of prices that are slightly higher than is strictly necessary. Indeed, with the average domestic/small consumer paying use of system charges of around £50 a year, we are certain that most consumers would prefer paying another few pounds to ensure that appropriate levels of investment are made.

The experience of infrastructure degradation in the railways (both in the national system and the London Underground network) makes the long term dangers of under-investment strikingly obvious. In the context of electricity, it is clear that significant levels of asset replacement will be required over the next price control period, and well beyond. In this context, it is essential that Ofgem should agree investment levels with the companies, rather than impose its model on them. Failure to get this aspect of the price control right could have far reaching consequences for consumers. We are expecting, and are prepared for, an open and robust dialogue with Ofgem and its advisors in this area.

The use of investment volume drivers can be useful where there is a reasonable degree of predictability in respect of unit costs (and where investment volumes can be measured). For example, this approach is being used by Ofgem in respect of Transco's low pressure mains replacement programme,[7] in relation to km of pipelines, by diameter. In the context of electricity distribution, cable and plant replacement programmes may be suitable areas for similar treatment, particularly if incentives were to provide for companies to outperform against the regulator's unit cost assumptions and thus achieve premium rates of return.

We agree with Ofgem that there is presently no clarity about how capex overspends will be treated. Ofgem appears to be concerned about the risk of companies deliberately overspending unless there is a disincentive to do so,

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[6] s3A(2)(b) electricity Act 1989, amended by Utilities Act 2000
[7] Ofgem, Review of Transco's Price Control from 2002: final Proposals, September 2001

such as a lower rate of return in the short term. We believe that at current regulatory rates of return such behaviour is most unlikely. Ofgem should only, in our view, be concerned about such behaviour if there is evidence that it is occurring. We doubt that it is, and, unless evidence to the contrary emerges, we believe that overspends should attract the normal rate of return. This is because companies would not have overspent except in response to a real need, such as maintaining or improving quality of supply.

Advanced investment to meet the potential requirements of future demand and generation customers would seem to require an incentive to ensure that companies make efficient choices. However, successful investment decisions should be rewarded at premium rates of return for two reasons. Firstly, it will be in the general interests of consumers and generators that companies get such decisions right, and, secondly, this approach avoids the need for the regulator to make difficult investment decisions (there being no market mechanisms available in this case). Clearly, any mechanism to reward efficient 'speculative' investment decisions will need some driver based on consumer or generator behaviour. MW of demand or generation capacity connected would seem to be a reasonable choice, and would be consistent with the connection notice procedure described in the Electricity Act.[8]

Financial issues

<u>Financial ring-fence and special administration arrangements</u>

Ofgem seeks views on whether there is a need to strengthen the financial ring fence in the light of complicated financing structures following recent mergers and acquisitions activity, and, in particular, in respect of associated inter-company transactions and financing arrangements. Ofgem also seeks views on the potential impact of special administration arrangements of the type described in the recent DTI consultation paper.[9]

The appointment of a special administrator, and the making of a scheme to transfer the licensee's assets and undertaking to a new licensee appointed by Ofgem or the Secretary of State should only occur where the company concerned is, or is likely to be, unable to pay its debts. Such a situation could arise for a number of reasons:

- An excessive flow of funds from the licensee to affiliates, such as excessive dividend payments to a parent company.

- Costs higher than regulated income, as a result of an external cost shock (for example a new tax) or an income shock (the failure of a major debtor/supplier).

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[8] s16 Electricity Act 1989, amended by Utilities Act 2000

[9] DTI Consultation on Proposals for a Special Administrator Regime for Energy Network Companies

- Management failure (such as an internal cost shock resulting from inefficient stewardship – for example, the realisation of an inappropriate contractual liability).

It is appropriate for the financial ring fence to address the first of these and any material weaknesses or defects in the current arrangements should rightly be Ofgem's concern. We are not aware of such major defects (although we appreciate that recent events concerning Aquila may have revealed the need for improvements).

No enforceable regime exists regarding cost shocks (the second bullet above). Ofgem has developed a tool for helping to identify the appropriate regulatory treatment of uncertainty. It should now develop these ideas into robust and enforceable rights such that a DNO cannot fail as a result of an external cost of income shock. Such mechanisms are clearly an integral party of achieving Ofgem's and the government's policy objectives regarding the financing of distribution licensees and minimising the risk of their financial failure.

Special administration arrangements are an appropriate safety net in the event of total management failure. A combination of financial ring fencing and an enforceable uncertainty mechanism should be able to address the other causes of failure identified above.

Cost of capital

EDF Energy has commissioned NERA to provide a commentary on Ofgem's approach to the cost of capital. A copy of that commentary was enclosed with our separate response to Ofgem's July consultation paper on the price control review for electricity distribution. In that response, we highlighted some of the key contributions made by NERA. We would refer Ofgem to the relevant parts of the separate response and also to the NERA paper as a whole.

Assessing the RAV[10] and the approach to depreciation

Ofgem's confirmation (p4.16) that it does not intend to change the method used for assessing the initial value of the RAB is welcome.

Ofgem proposes that companies will retain the benefit of asset disposals or transfers out for five years, when a RAV deduction based on the proceeds will be made (4.17). This approach would leave companies with only the cost of capital and regulatory depreciation for five years, which may be very small. By writing down the RAV with the amount of the proceeds, any value above the depreciated RAV value would be lost and returned to customers. An approach which shared any sale proceeds above the written down value for five years would provide stronger and more equitable incentives. Any new arrangements must not be applied retrospectively.

[10] Regulatory Asset Value

We note Ofgem's view (p4.19) that any changes to the approach to regulatory depreciation will take account of inter-generational allocation issues. Clearly, any such changes will need to take account of each company's ability to raise capital at an appropriate cost. This in turn will be strongly influenced by future cash needs and the company's current and future debt profiles.

Accelerated erosion of RAVs would destabilise companies' finances and raise the cost of capital. We expect this issue to be relevant and significant in the forthcoming distribution price control review because of the increasing investment needs. We will work closely with Ofgem in developing its financial modelling to find acceptable trade-offs between the short and long terms.

Treatment of pension fund costs

In paragraph 4.35 of its June consultation paper, Ofgem sets out its initial guidelines on how it intends to treat pension costs when setting network operator price controls. We comment on each guideline in turn below.

- *Customers of network monopolies should expect to pay the efficient cost of providing a competitive package of pay and other benefits, including pensions, to staff of the regulated business, in line with comparative benchmarks.*

We have reservations about this guideline in this form as it is unclear what Ofgem means by 'competitive package' and 'comparative benchmarks'. Considerable care would need to be taken by Ofgem in any benchmarking exercise to ensure that comparability is achieved regarding the various mix of remuneration components (salary, bonuses, allowances, pension, 'fringe' benefits, perquisites and stock options). Furthermore, distributors carry unique legal obligations in respect of pension schemes (see the Electricity Act 1989, section 104 and Schedule 14). Basing price control allowances on what may be perceived as competitive packages, outside the distribution sector, is therefore inappropriate, unless suitable adjustments are made to take account of the differing legal obligations.

- *In principle, each price control should make allowance for the ex-ante cost of providing pension benefits accruing during the period of the control, and similarly for any increase or decrease in the cost of providing benefits accrued in earlier periods resulting from changes in the ex-ante assumptions on which these have been estimated.*

We agree with this principle. As is now well known, the costs of providing pension benefits are increasing for a variety of reasons. These include greater human longevity, low interest rates, and the ending of dividend tax relief for pension funds. At the same time, recent substantial falls in equity markets have contributed to a growing shortfall in the adequacy of pension fund assets to meet their rising future obligations.

To the extent that the assumptions used to forecast future conditions have fundamentally changed, reflecting the impact of uncertainties beyond the reasonable control of distributors, an increase funded by the price control in future contributions to pension funds is clearly justified by the principles of incentive regulation.

We accept that claims for higher revenues to cover higher pension costs should be supported by proper actuarial evidence of need. But, subject to that, it is clearly appropriate for Ofgem, at a price control review, to allow distributors the additional costs of pension liabilities to reflect the expected future cash outlays for those liabilities. Such ex-post correction should include the financing costs associated with the quantum of the correction. A re-opening of the price control may be necessary should the funding shortfall adversely impact on the ability of a company to finance its activities.

- *Pension costs should be assessed using actuarial methods, on the basis of reasonable assumptions in line with current best practice.*

This guideline seems insufficiently precise. In particular, the concept of 'current best practice' should, in our view, be defined as the methods and standards specified by the statutory professional bodies for actuaries in England and Scotland.

We note Ofgem's initial view that its estimates of pension costs should be based on the next triennial actuarial valuation of the ESPS as at 31 March 2004, and that changes to the traditional timetable may be needed to achieve this. However, we do not believe that this is practicable, given the length of time needed to complete that valuation. It would also seem to be inappropriate (and in law it may be ultra vires) for scheme trustees to authorise changes to the timetable for extrinsic purposes.

- *Increases or decreases in the future costs of providing accrued benefits resulting from under or over funding in prior periods will need to be considered on a case by case basis.*

Given that each licensee's price control is decided on a case by case basis, this guideline appears to add little. We believe that Ofgem should be specific about the principles to be employed when considering such matters, since clarity and predictability of approach are essential.

Going forward, it will be a prerequisite of ex ante correction that Ofgem's price control assumptions in respect of pension costs are fully documented and made available to all the individual companies concerned.

- *Increases or decreases in the future cost of providing accrued benefits resulting from differences between ex-ante and ex-post investment returns in prior periods will also need to be considered on a case by case basis.*

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This guideline similarly adds little to our understanding of the principles that Ofgem would use in relation to this matter. Here again, clarity and predictability of approach are essential.

At paragraphs 4.28 and 4.35, Ofgem says that, in carrying out previous reviews, it 'has not looked at pension costs and their funding in isolation' and adds that 'it will not be straightforward to establish what allowances for pension costs were implicit in earlier price controls'. We are therefore concerned at Ofgem's subsequent conclusion, seemingly reached on pragmatic grounds, that it might be appropriate to assume 'that the implicit annual allowance was equal to the efficient and attributable proportion of the company's recorded accounting charge based on headcounts and average unit payroll costs'.

Operating cost allowances were set at the last price review in relation to the standardised controllable costs of two 'frontier efficient' companies. By this method, Ofgem effectively spread the assumptions made by these two companies (and the assumptions underlying Ofgem's various cost adjustments) across all the companies. The impact of any reduced contributions in respect of pension costs on the costs of the two frontier companies was therefore applied to all the other companies. It would be inappropriate to ignore the effect of this, as suggested by Ofgem, and we therefore do not agree with this approach.

- *Liabilities in respect of the provision of pension benefits that do not relate to the regulated business should not be taken into account in assessing the efficient level of costs for which allowance is made in the price control.*

We are concerned about this guideline for the following reasons**:**

(a) Prior to the legal separation of the supply and distribution businesses, the distribution business was purely an accounting and regulatory construct within a single legal entity (the public electricity supplier, or PES) created by statute. Liability for pension costs rested with the PES rather than with the specific regulated businesses.

(b) Statutory transfer schemes, authorised by the Secretary of State, have resulted in the distribution business successor carrying the cost of current pension obligations and of historic redundancy payments associated with employees who left in the past and whose activities would not now be classed as distribution activities.

(c) The cost of pension obligations caused by these past employees derives from statutory obligations that distributors cannot reduce or avoid, and that are not imposed on other companies. Ofgem should make allowance for recovering the cost of such obligations, since that cost is unavoidable.

(d) It would not have been appropriate to transfer such obligations to any competitive business unbundled from distribution. The actual size of the obligation would have depended on past levels of efficiency and past efficiency gains, and not on the efficiency with which the new supply business (for instance) was able to carry out its activities. Clearly such businesses are now in competition with other businesses unencumbered with such obligations and so would be unable to recover the costs. More fundamentally, to have knowingly put the payment of such obligations at greater risk would have breached the statutory duties of fund trustees.

(e) Ofgem's statement is also inconsistent with its stated principle of setting the allowances for pension costs ex-ante with ex-post correction (see, for example, paragraphs 3–5 above). The scope of the distribution businesshas changed in response to changes in regulatory and government policy over time. Before April 2000, for example, the business included the activities of meter reading, data processing, and data aggregation. From April 2000, these activities were transferred to supply businesses and are now part of a competitive market. The ex-post correction of pension cost assumptions before that time in respect of such activities must therefore remain within the distribution price control.

- *Companies will also be expected to absorb any increase (and may retain the benefit of any decrease) in the cost of providing enhanced pension benefits granted under severance arrangements which have not been fully matched by increased contributions.*

This guideline is unacceptable. To explain our view, we need to look back at Ofgem's past price control treatment of the costs of restructuring:

(a) Following the 1995 price control re-review, any allowance for the redundancy payments that were needed to achieve expected cost savings was disallowed. This regulatory policy stemmed from the 1995 report of the MMC on Scottish Hydro-Electric plc[11], which concluded that 'redundancy programmes should be self-financing out of the savings to be made in future years'. In the revised 1995 price control settlement, therefore, Ofgem explicitly noted the MMC's decision and stated that:

'[We] have reduced the allowance for restructuring costs, and propose to reflect this by increasing the X value for all the RECs from 2 to 3'. [12]

'The consequent reduction in allowed revenue removes most of the allowance that [we] made for redundancy costs: this still leaves the RECs some recognition for other restructuring costs'.[13]

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[11] Scottish Hydro-Electric plc; A report on a reference under section 12 of the Electricity Act 1989 MMC, May 1995

[12] The Distribution Price Control: Revised Proposals, Offer July 1995, Executive Summary

[13] The Distribution Price Control: Revised Proposals, Offer July 1995, Paragraph 8.7

Since Ofgem had previously included an allowance for redundancy costs, it must be reasonable to assume that Ofgem had also assumed a certain number of redundancies when calculating the allowance for future labour costs. By then deducting the allowance for the redundancy costs (without apparently making any offsetting adjustment to labour costs), Ofgem in that review was immediately passing on to customers the expected saving from the redundancies. Customers therefore benefited directly from such savings without being required to contribute, in any way, towards the expected cost of the redundancy programmes.

In Ofgem's 1999 price control review papers[14], there is no detailed specific reference to the treatment of pension costs (other than to note that they are one of a number of additional costs of employment within total payroll costs), but we may assume that the same regime was in operation. In any event, in setting the price controls from 2000, Ofgem will have inevitably taken into account the fact that pension schemes were in surplus and that therefore there was no need to allow for redundancy costs.

While previous regulatory decisions have explicitly ruled out giving a revenue allowance for enhanced pension and redundancy payments, Ofgem's regulatory policy has (implicitly and in fact) been to allow revenues to cover payments into the fund. It would be inconsistent for Ofgem to change that policy now, just because payments into the fund represent a cost that is increasing.

(b) This is a new policy which, as we have shown, would be inconsistent with past regulatory policy. Ofgem attempts to explain its new policy thus:

'This means that in cases where companies have used enhanced pension benefits to encourage early retirement as part of a set of measures to improve efficiency or restructure the business but, in view of a pension fund surplus existing at the time, have not made contributions to fund the increased cost of providing such benefits, the company should first make good this element of any deficit before any increased pension costs are passed on to customers.

'To do otherwise would be unfair to companies which have borne the full cost of staff rationalisation themselves. It might also result in customers paying twice for severance costs for which explicit allowance was made in some previous price controls'.

An Ofgem document of May 1999 states that 'the PES payroll costs include the additional costs of employment associated with National Insurance payments, pension costs and overtime/bonuses'. Review of Public Electricity Suppliers, Distribution Price Control Review: Consultation Paper, Ofgem, May 1999, Annex 1

This paragraph ignores the precedents outlined above, which indicate that, so far, customers have not paid for the investments needed to achieve the large cost savings from which they benefited directly in the past. Since they did not pay for the original redundancy payments, it cannot be argued that customers would be 'paying twice' if they are now to provide revenues to cover the cost of additional pension contributions. On the contrary, this would be the first opportunity that distributors have had to recover the cost of the investments they made to reduce their workforce.

(c) Ofgem's concern that any other approach would be unfair to companies which have funded the full cost of staff rationalisation themselves seems to be irrelevant. If companies have legitimate costs to recover, which havenot been provided for in the past, then Ofgem needs to allow their recovery now.

In an earlier part of its paper, on the general principles of price control regulation, Ofgem sets out its concerns about the potential for loopholes in the regulatory framework that would 'allow companies to benefit financially from behaviour that is contrary to their duties or to consumers' interests'. Ofgem describes such behaviour as 'gaming the system' – that is, the taking of a high risk approach for short-term rewards – and warns that any company doing this 'must not expect to recover any additional costs that might be involved in reversing its position'.

It is therefore worrying that, of the only two examples given by Ofgem of such gaming, one relates specifically – and inappropriately – to pensions-related behaviour**:** 'Companies that make use of pension fund surpluses to fund staff reductions should not subsequently expect funding from consumers through the price control to make up any resultant shortfall in the pension fund – this is the responsibility of the company and ultimately of its shareholders' (p2.7).

As we have shown above, past regulatory decisions are not consistent with Ofgem's contention that the cost of extra pension fund contributions attributable to past redundancy payments is a cost that must be borne by companies and their shareholders. The contention also ignores the fact that, since shareholders provide capital and do not 'bear costs', preventing distributors from recovering legitimately incurred costs will simply drive up the rate of return that shareholders require.

Ofgem's paper does not spell out how a distributor might have gamed the system (in Ofgem's terms) under the existing and/or previous distribution price controls. For such a charge to stick, however, Ofgem would have to be able to demonstrate on a case by case basis that**:**

(a) The distributor encouraged workers to leave the industry during the 1990s by making large redundancy payments out of the pension fund;

(b) The redundancy payments were ‘overly generous’, in that they exceeded a prudent estimate of the resulting cost saving to the pension fund; and

(c) The distributor expected Ofgem to react to this accumulating problem by raising future allowed revenues.

It should be noted in these respects that:

(a) During the period in question, companies could prudently have withdrawn pension fund surpluses and used them for other purposes, since those surpluses were essentially money belonging to the companies;

(b) Companies would have been required by law to ensure that redundancy payments did not deplete the funds available to cover other liabilities of the pension fund; and

(c) It is most unlikely that the predecessors of the current distributors during the 1990s would have had much, if any, confidence in the prospective link between costs and revenues ten or more years later.

Accordingly, we believe that in principle there are no grounds for Ofgem to disallow the recovery of appropriate pension contributions as a normal business cost of the distributors. Therefore, Ofgem should now make allowance for any additional cost of replenishing pension funds, to the extent that previously assumed surpluses were used to fund cost saving programmes, from which customers have been benefiting in lower prices.

EDF Energy plc
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