

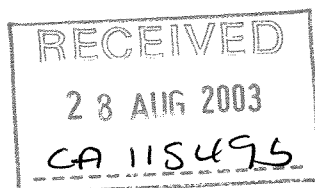


National Grid

Date:

22 August 2003

Cemil Altin
Head of Price Control Development
Ofgem
9 Millbank
London
SW1P 3GE



Transco

NGT House
Warwick Technology Park
Gallows Hill
Warwick CV34 6DA

Tel No: 01926 653140
email: tim.tutton@ngtuk.com

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Dear Cemil

Ofgem's initial conclusions on developing network price controls

I attach National Grid Transco's response to the above. Specifically:

- Attachment 1 covers our response to the initial conclusions on regulatory treatment of pension costs; and
- Attachment 2 covers our response on other issues raised in the document.

Please get in touch if you would like to discuss any of these issues further.

Yours sincerely

Tim Tutton
UK Director of Regulation, National Grid Transco



Attachment 1

Treatment of pension fund costs in future price controls

Summary

- 1 Ofgem is proposing that customers should pay for the pension costs of the energy network businesses to the extent that certain conditions are fulfilled. These conditions/principles are set out in the form of seven proposed guidelines. In effect, Ofgem is proposing that pension costs should be treated as a pass-through as long as companies have not themselves made the costs greater than they needed to be, e.g. through paying less cash into schemes than has been assumed when setting price controls or through using scheme funds for purposes which Ofgem considers inappropriate.
- 2 We welcome several features of Ofgem's proposals, especially the recognition that many of the factors which affect the financial health of pension schemes are beyond the companies' control. We support Ofgem's view that it is appropriate for customers to bear the risks (and take the benefits) associated with changes in these external factors which have not been anticipated when price controls were set.
- 3 At the same time, we take issue below with several of Ofgem proposed guidelines which would have the effect of, inter alia:
 - (a) taking further bites at past price controls, even though all but the current price controls have all been, in principle, 'corrected for' in the following price reviews;
 - (b) potentially clawing back revenue from past price controls on the basis of (necessarily) crude estimates of how past price controls might have been set if the regulatory body at the time had seen fit to publish the detailed basis of its price control proposals with respect to pensions, even though past price controls may not have been based on any particular assumption about pension costs and even though Ofgem has been steadfast, to date, in its position that price control proposals are a 'package' and have not been dependent on detailed individual assumptions;
 - (c) in general, using the benefit of hindsight to represent as unreasonable decisions which were eminently reasonable in the context of the information available at the time that they were made, not least in respect of arrangements which were put in place at the time of the de-merger of Centrica from British Gas; and
 - (d) penalising decisions which have been for the clear benefit of customers, not least with respect to the use of pension fund surpluses to part-fund severance programmes which had not been assumed in the setting of price controls.
- 4 In sum, it is our view that Ofgem has not made a case for disallowing any material part of the pension costs likely to be incurred by, for example, Transco or NGC and the detailed reasons for this position are set out in our responses below to each of the proposed guidelines.

Ofgem's proposed principles

- 5 Ofgem's principles (numbered by us to make discussion of them easier) are as follows:

Guideline 1

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

Guideline 2

In principle, each price control should make an allowance for the ex ante cost of providing pension benefits accruing during the period of the control, and similarly for any increase in 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.

Guideline 3

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

Guideline 4

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.

Guideline 5

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.

Guideline 6

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.

Guideline 7

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.

- 6 Below, we respond on each of these in turn.

Guideline 1

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.

- 7 We welcome Ofgem's recognition that pensions are a normal part of a regulated business's operating costs and, as such, should be paid for by customers if efficiently incurred.
- 8 We also welcome Ofgem's recognition that pension costs are one component, albeit an important one, of the wider remuneration package – and that, therefore, 'efficiency' of pension costs can only be assessed in that wider context. Given that, we are not aware that, in any past energy network price review, any network company's overall remuneration package has been judged to be significantly out of line with the relevant benchmarks.

Guideline 2

In principle, each price control should make an allowance for the ex ante cost of providing pension benefits accruing during the period of the control, and similarly for any increase in 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.

- 9 We agree with this guideline which, when combined with Guideline 5 below, implies that customers bear the risk of changes in the financial health of pension schemes due to factors which are, in effect, outside the control of network companies themselves.

Guideline 3

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

- 10 This guideline seems to us slightly more complicated than it first appears and strongly interactive with other guidelines (especially 2 and 5). Two issues, in particular, would seem to underlie it, viz:
- (a) the use of a forecast of required cash funding of the relevant pension scheme during the price control period in question, rather than an accounting provision based on the underlying cash requirements of the scheme; and
 - (b) the extent to which Ofgem might adjust or second-guess the recommendations of the scheme's actuary.

Forecast cash requirements for a specific period versus accounting provision

- 11 It seems to us that the use of a period-specific cash-based approach is appropriate in the context of the total package of guidelines which Ofgem is proposing. Specifically, if Ofgem was proposing that companies should bear the risks associated with routine fund under and over-performance or with unexpected changes in factors bearing on longer term funding requirements, then it would make sense to base price controls on SSAP 24 provisions, which are based on **underlying** pension costs, with the

expectation that, in the event, actual cash costs in a particular period might turn out to be greater or less than these.

- 12 In fact, and via Guidelines 2 and 5, Ofgem is proposing that those pension costs which are effectively outside the control of the network businesses should be passed through to customers. Given this, it makes sense for price controls to be based on the best expectation of cash requirements in the price control period in question and for the following review to adjust for any difference in the out-turn for that period.

Adjustments to actuary's recommendation

- 13 Having said this, however, it is not totally clear how Ofgem intends to come to a view on the best expectation of what the cash requirements will actually be. For example:

- (a) Will companies be required to have a full actuarial valuation at the time of a price review?
- (b) Will Ofgem necessarily accept the views of a scheme's actuary, especially when there are differences of view and assumptions between actuaries of different schemes?
- (c) If the scheme actuary's view is not accepted, what would be the basis for second-guessing the actuary's view?

- 14 In practice, many of the questions associated with this guideline will be less important if Guidelines 2 and 5 are followed. These would imply that, if the cash requirements in the price review period in question, eventually turn out to be different from what was expected at the time of the previous price review, then differences between expectation and outcome will be factored into the subsequent price control.

Guideline 4

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.

- 15 Ofgem's proposal is, in effect, that:
- (a) Past final price control proposals should be de-gutted to extract the assumed level of company contributions to pension schemes.
 - (b) These figures should be compared with actual cash payments into the schemes.
 - (c) Where companies have paid in less than the amount estimated (retrospectively) to have been incorporated into the relevant price control, then companies should absorb the contribution this difference has made to any pension scheme deficit (i.e. the initial contributions 'deficit' plus forgone investment returns).
- 16 Ofgem recognises that it will often not be possible to determine what level of pension contributions was assumed in setting price controls – by implication, because pensions were not seen as an issue at the time. It therefore proposes that, in the absence of better information, "it might be appropriate to assume, for these purposes, 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". The presumption is that the relevant accounting charge would be in the 'base year' used to set the particular price control.
- 17 We have a number of comments both on the principle implied by this guideline, as well as on the proposed method for implementing the guideline. These cover:
- (a) the lack of consistency of the guideline with Ofgem's overall approach to price controls;
 - (b) even if retrospection was implemented:
 - (i) the question of how far back in time such retrospection should go;
 - (ii) the need for inclusion of severance-related pension costs in any such exercise; and
 - (iii) the need for symmetrical treatment as between, on the one hand, situations where company payments into pension schemes have been less than assumed in the setting of the relevant price control and, on the other hand, where company payments have exceeded the amounts assumed.

18 Each of these points is covered in turn.

Consistency of the guideline with Ofgem's overall approach to price controls

- 19 One of the themes underlying Ofgem's approach to price controls for both NGC and Transco has been a more or less consistent refusal to engage in debates about the detailed assumptions underlying the opex component of Ofgem's price control proposals. This has been on the (sometimes explicit, sometimes implicit) basis that companies would only focus on those assumptions which would be to the company's advantage and that such detailed discussions would be systematically biased in the company's favour. In the case of the DNOs, the benchmarking/frontier company dimension of the price control setting process has further divorced the price control for an individual company from any detailed assumptions about the operating costs of that company.
- 20 This debate has recently re-surfaced in the context of Ofgem's proposals for the regulatory accounts of the network businesses. Ofgem has proposed that the accounts should allow a highly detailed, line-by-line comparison of opex out-turn numbers with the assumptions made in setting the relevant price control. However, it has been pointed out to Ofgem that companies such as NGC and Transco were, at the time of their price reviews, never made aware of the detailed assumptions underlying Ofgem's proposals (Ofgem justifying this on the basis given in the above para and always emphasising the point that price control proposals were "a package") – and that, therefore, there was no basis for such a comparison. Maybe partly in response to this point, Ofgem's proposals on regulatory accounts for NGC and Transco would currently seem to be on hold.
- 21 We think it actually highly desirable that **future** price reviews **should** entail line-by-line comparisons of opex assumptions between companies and Ofgem, not just as a matter of general good regulatory practice but also because it will specifically assist in the application of the proposed rolling retention of the benefits of out-performance against price control assumptions. (This point is elaborated in Attachment 2 of our response to Ofgem's initial proposals.) Therefore, we would agree with the proposal to inform future price controls with line-by-line comparisons of outcomes with price

control assumptions (for all lines and not just for pensions) in **future** price control periods.

- 22 However, the fact remains that neither Ofgem nor its predecessors typically made available detailed assumptions underlying the opex component of past price control calculations, whether in respect of pensions or anything else, and defended this as a matter of principle. For this reason, it is our view that, for Ofgem now to try to de-gut the pension assumptions underlying past and current price controls (and leaving the practicality of undertaking this exercise until paras 25-26 below), would be quite inconsistent with Ofgem's philosophy in setting price controls to date and, therefore, the sort of retrospective regulatory practice which frightens investors and increases the cost of capital for regulated businesses.

If implemented, how far back should retrospection go?

- 23 If, in spite of the above, Ofgem does decide to press ahead with a detailed comparison of payments into pension funds with (estimated) price control assumptions, the question arises as to how far back such a comparison can reasonable go. This question is a matter of both:
- (a) principle; and
 - (b) practicality.
- 24 In **principle**, at each price control review, Ofgem and its predecessors have looked back over the period since the last review and have taken what has happened in that period into account, including any overall divergence between outturns and previous price control assumptions, when setting the new control. Therefore, it is hard to see how, as a matter of principle, Ofgem can justify re-opening issues with price controls before the current control period. In the absence of this principle, there would seem to be the potential for substantial regulatory uncertainty because of the risk that hindsight will, in future, again reveal some issue which should have been dealt with differently some time in the more or less distant past. On this basis alone, retrospection for the DNOs should go back only to April 2000, for NGC to April 2001 and for Transco to April 2002. This issue of 'Second Bite' (or third or fourth bite) retrospection is picked up again under Guideline 7 below.
- 25 The issue of principle is compounded by the issue of **practicality**. As Ofgem itself recognises, the further one goes back in time, there is little or no audit trail for what was, or might have been, assumed about pensions when setting price controls. This is why Ofgem suggests the use of company SSAP 24 provisions (at least as a starting point) in the absence of better information.
- 26 However, the issue of flaky data is compounded by the history of equity returns since the companies in questions were privatised. Because of high returns through the 1990s, and because of Ofgem's proposal that companies should be liable for both any under-payment into pension schemes (relative to price control assumptions) and for foregone investment returns, the implication of Ofgem's proposal is that going back more than a few years exposes companies to a potential double whammy. In other words, the further Ofgem goes back, not only is each £ of alleged 'under-payment' a matter of more contentious retrospective estimation but also each £ will have a bigger multiplier attached to it in terms of the potential hit for shareholders.
- 27 On the basis of the above, both practicality and reasonableness reinforce the proposition that retrospection should, at most, only go back as far as the recent past.



The need for any retrospection to include severance-related pension costs

- 28 On the basis of the above, any retrospection would only be reasonable if there were hard data to underpin any analysis. However, any comparison of payments into pension schemes with what can reasonably be demonstrated to have been assumed when setting price controls needs to also include severance-related pension costs in that comparison.
- 29 To do otherwise would lead to counter-intuitive and unreasonable consequences. For example, take a company which performs exactly as assumed when setting its price control except that it implements a larger than assumed severance programme – thus incurring higher severance costs and also lower ongoing pension costs (because of fewer employees). If severance-related pension costs are excluded from the comparison, then the company could be penalised ‘under-spending’ its ongoing pension cost ‘allowance’ - whereas, overall, it will probably have paid more into the fund than assumed.
- 30 Furthermore (and this is a point picked up again under Guideline 7 below), to the extent that severance programmes exceed those assumed by the Regulator when the price control was set, the majority of the benefit of this is passed straight back to customers at the next review. The table on page 25 in the Initial Proposals paper shows between 71% and 87% of the benefit of ongoing opex reductions accruing to customers.
- 31 Therefore, overall, any comparison between payments into pension schemes and price control assumptions needs to take account of severance-related pension costs.

The need for symmetry

- 32 Ofgem states (on page 53) that “where the level of employer contributions made to the relevant scheme in any year was below the price control allowance companies will be expected to absorb any increase in future pension costs to the extent the revenues related to pension costs allowed for under the price control have not in fact been contributed to the scheme (including in respect of investment returns foregone)”.
- 33 Although this may just be a question of drafting, Ofgem does not explicitly consider the case where pension contributions have **exceeded** the estimated price control assumption. Any consideration of reasonableness implies that any analysis, along the lines proposed by Ofgem, should be symmetrical as between contribution surpluses and deficits relative to price control assumptions.

In sum

- 34 In sum:
- (a) There is no justification in principle, and substantial difficulty in practice, in Ofgem basing any future price controls on an analysis of past pension contributions, relative to price control assumptions, before the current price control periods.
 - (b) Any analysis of the current price control periods needs to be symmetrical as between under and over-contributions as against price control assumptions.

Guideline 5

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.

- 35 Ofgem suggests that “... in the absence of significant evidence of material stewardship failure it would not be appropriate to specifically reward or penalise companies whose pension funds have realised above or below average investment returns, compared to other schemes having comparable liability profiles”. Ofgem goes on to recognise that this would imply customers bearing the risk of fund under-performance and benefiting from out-performance.
- 36 We agree with this guideline. In effect, and as with Guideline 2 above, it is a particular application of the general proposition that it makes sense to pass through to customers costs which the network companies cannot, in any reasonable sense, control. Companies can be expected to exercise reasonable stewardship, with respect to, say, choices of fund managers or high level decisions on asset allocation but, beyond this, fund performance **will** be beyond the control of the network businesses.

Guideline 6

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.

- 37 This guideline implies that, where activities are de-merged from a regulated entity and the pensioners and deferred pensioners (‘deferreds’) of the whole entity stay with the regulated company, only a proportion of any deficit should be attributable to regulated customers. Ofgem suggests that its proposed guideline should not be controversial. This would imply that Ofgem has considered, and found answers supporting its position to, the following questions:
- (a) Did the company in question have the option to split the pensioners and deferreds (at the time of the de-merger) between the two relevant corporate entities?
 - (b) If not, was it reasonable to assume at the time of the de-merger that the lack of a split would be disadvantageous to regulated customers or that the rump company should have put in place risk sharing arrangements between itself and the de-merged entity to protect the customers of the rump company?
 - (c) Did the actions of regulators, including the MMC, at the time or in the wake of the de-merger, suggest that there should be any sort of ‘regulatory partitioning’ of the relevant pension scheme?
 - (d) Given that this guideline suggests that ‘unregulated’ liabilities should not be taken into account in setting price controls, does it therefore follow that unregulated **assets** (e.g. pension surpluses attributable to unregulated entities) should likewise be excluded?
- 38 Each of these questions is considered in turn and, in our view, the answers suggest that there is no reasonable basis for not taking into account the overwhelming bulk of the costs associated with, for example, the Lattice pension scheme when setting Transco’s next price control.

Did British Gas have the option to split the pensioners and deferreds in the British Gas pension scheme between BG and Centrica

- 39 This question, in turn, raises other questions, e.g.:
- (a) Would it have been possible to identify pensioners/deferreds who should have been allocated to Centrica?
 - (b) Could such people have been compelled to transfer to a Centrica pension scheme?
 - (c) What was normal market practice at the time with such de-mergers.
- 40 To these questions, the respective answers are that:
- (a) It would not have been possible to identify, in general, which pensioners/deferreds should have transferred to a Centrica pension scheme.
 - (b) Even if had been possible, any such transfer would have had to have been agreed by the people affected who, on the basis of available evidence, would not have so agreed.
 - (c) According to our actuarial advisers, for the majority of corporate transactions, an 'actives only' transfer is typical practice.
- 41 On the basis of these answers, it would be unreasonable to expect British Gas' pensioners and deferreds (at the time of the de-merger) to have been split between the pension schemes of the two companies.
- Should there have been special arrangements between BG and Centrica to share risks associated with the British Gas pension scheme between the two companies?**
- 42 However, even accepting the proposition in the above para, there is the question of whether it would have been reasonable at the time to expect risk sharing/underpin arrangements to have been put in place between the two companies. In our view (and in the view of our actuarial advisers), it would not have been reasonable to have expected such an arrangement to have been put in place at the time. This is not least because:
- (a) It would have been unusual at the time to have negotiated either an adjustment to the purchase price to reflect the non-transfer of non-active pension liabilities or underpins or guarantees against the background of continually rising equity markets. (In contrast, BG and Centrica did enter into an agreement with respect to **insurance** liabilities which were recognised as an issue at the time.)
 - (b) The pension scheme was in substantial surplus at the time.
- 43 Companies are now much more aware of the risks associated with the liabilities accrued under defined benefit pension schemes – but this was not true at the time of the demerger, a fact echoed by the attitude of the regulatory authorities, including Ofgas and the MMC at the time of, and in the wake of, the demerger (see below). For Ofgem to suggest otherwise is to imply a substantial degree of hindsight benefit.

At the time of, or in the wake of, the de-merger, did either Ofgas or the MMC imply that there should be any sort of regulatory partitioning of the British Gas pension scheme?

- 44 The Centrica de-merger happened in February 1997. Since then, two price controls have been set, one by Ofgas/MMC later in 1997 and one by Ofgem in 2001. Neither price controls seemed to have envisaged any regulatory partitioning of the overall pension scheme and on both occasions the arguably 'Centrica' element of the surplus seems to have been used for the benefit of customers. It is not clear that Ofgem's proposal of Guideline 6 entails reversal of this benefit.

Is there, therefore, any reasonable basis for such partitioning going forward

- 45 In our view, and not least on the basis of the above, there is not. Ofgem has stated that, in effect, if it made mistakes in the past, then it does not feel bound to perpetuate them. This is, in our view, not the point. The point is, rather, that British Gas and Ofgas and the MMC all made past decisions which were reasonable at the time. It would therefore be unreasonable to now believe that British Gas should have acted differently or that Ofgem should now take decisions on the basis that British Gas should have anticipated what virtually no one else did. The only basis for applying Guideline 6 to the Centrica de-merger would be that the parties concerned behaved unreasonably at the time. There is absolutely no evidence for this.
- 46 More broadly, Ofgem itself allows (para 4.29) that "Pension costs and their funding have ... not generally been an issue in previous price control reviews". This is an important point, from which Ofgem seems unwilling to draw reasonable conclusions. It is not only Ofgem (and its predecessors bodies) which have only recently focused on the issue of pensions. The same has been true for most of UK industry and Government. Because of this, there is a real risk of decisions being taken with the benefit of hindsight, not least in relation to arrangements which should have been put in place when network businesses have been separated from larger corporate entities.

Should account also be taken of 'unregulated' pension surpluses?

- 47 As with the text accompanying Guideline 4, the text which accompanies Ofgem's Guideline 6 focuses on circumstances in which Ofgem thinks that companies should remedy a deficit before consideration is given to raising prices to customers. However, as also with Guideline 4, any consideration of reasonableness implies the need for symmetry, in this case as between the regulatory treatment of unregulated deficits and unregulated surpluses. For most of the period since privatisation, energy companies' pension schemes have been in surplus. As a result, where corporate activity has led to non-regulated pension obligations being retained by regulated entities, the pension funding costs of regulated activities, both actual and 'allowed', have been reduced by the surpluses attributable to the non-regulated liabilities. Under the guideline proposed by Ofgem, this 'reverse cross-subsidy' would need to be taken into account.

In sum

- 48 In sum:
- (a) The decision to not split the pension fund between British Gas and Centrica was unavoidable.
 - (b) The decision not to put in place a risk-sharing arrangement, respect of the pension fund, between the two companies was reasonable in the light of information available at that time.

- (c) Regulatory bodies did not, at the time of or in the wake of the merger, take a different view or take the view that there should be regulatory partitioning of the pension scheme.
- (d) For Ofgem to come to a different view now could only be on the basis of hindsight – and hindsight is neither a normal nor a safe basis for taking regulatory decisions.
- (e) In any event, any such view, however unreasonable, would need to take account of the benefit which Transco's customers have had historically from the 'Centrica' part of the Lattice fund pension surplus.

Guideline 7

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.

- 49 Ofgem's apparent target with this guideline is the use of pension fund surpluses to fund severance programmes, even when those severance programmes have been incremental to anything which has been assumed when price controls are set. More specifically, what Ofgem is proposing is that if, for example, £10m of pension fund surplus were used to part-fund a severance programme whose funding was not assumed in setting the relevant price control, then, when calculating the next price control, a sum of money will be deducted from allowed revenue which is equal to that £10m plus the investment returns which that money would have earned over the intervening period.
- 50 In our view, this guideline is inappropriate for setting the next round of price controls for the following two main reasons:
- (a) As with Guideline 4, this guideline would imply 'second-bite' retrospection, **second-bite** because the use of surpluses in the way outlined was well known at previous price reviews and because no regulatory action was taken other than to pass the benefits of the resulting cost savings on to customers. The main effect of such second-bite retrospection is simply to raise the cost of capital for regulated businesses.
 - (b) Customers have benefited substantially from the use of surpluses to fund severance programmes which have been in excess of those assumed when setting price controls. To penalise companies for actions which have benefited customers would seem both perverse and inconsistent with Ofgem's primary duty to customers.
- 51 Each of these points is discussed in turn below.

Second bite retrospection

- 52 Other things being equal, Ofgem's guideline would be more justifiable if the fact of network businesses using surpluses to part-fund severance programmes had been a somehow covert practice which had come to light only since the last price reviews. This is clearly not the case. NGC, for example, first began using its pension fund surplus in this way in 1992. Both Offer and Ofgem were aware of this practice at the time of both the 1996 and 2000 price control reviews, not least because the issue was the subject of prolonged litigation, culminating in its consideration by the House of Lords. In neither review was any comment passed by the Regulator, let alone any

adjustment made to revenue. Instead (and this point is expanded below), the resulting opex savings were simply passed straight on to customers.

- 53 Such second bites at a **given** company action are not good regulatory practice. In principle, they imply that no past action by a regulated business will ever be definitely judged by the Regulator to be acceptable (or, at least, not judged to be unacceptable). Thus, companies are vulnerable to continual review of a given past action, even when there has been no new information about what was a reasonable action to take in the circumstances of the time. When, as in this case, the information in question goes back over 10 years, the scale of regulatory risk created is even greater. The main effect of second-bite retrospection is to increase investor's perception of the risks facing regulated business and, thus, raise the cost of capital for such businesses.

Customer impact of the use of pension fund surpluses

- 54 Neither Transco nor NGC have been subject to benchmark regulation when setting their price controls. This is because of the lack of suitable benchmarks, despite considerable effort by Offer, Ofgas and Ofgem to find them. Because of this, when setting price controls for the two companies, regulators have started with the efficiency improvements achieved, to date, by the companies themselves before deciding what further efficiencies might be achieved during the next price control period. This contrasts with DNO price reviews where the starting point has been a mixture of what has been achieved by the company in question and what has been achieved by companies judged to be on the 'efficiency' frontier.
- 55 Because of the lack of benchmarking, the effect of company's own past performance has a much more direct impact on the price control set for the following period. Out-performance against price control assumptions has, in the past, simply passed straight into the starting point for setting the new price control. Ofgem is proposing that, in future, this process will be mediated by a rolling mechanism whereby companies keep the benefit of out-performance for longer, at least if out-performance has been achieved other than at the beginning of a price control period – but the impact of this proposal is simply to slightly delay the benefit to customers of a given cost reduction (and therefore to encourage greater cost reductions).
- 56 Despite this benefit to customers from cost reductions, the incentives on NGC, in particular, to achieve those cost reductions has been quite weak. Unlike other regulated business which have had five year price control periods since privatisation, NGC is currently in its first five year period. Previous periods have been for three, four and four years respectively. The implication of these shorter periods has been, on the basis of Ofgem's own analysis, that the company has kept less than a quarter of the benefits of out-performance against price control assumptions. Some of the severance programmes required to deliver out-performance against price control assumptions would have, in fact, delivered distinctly marginal returns to shareholders without the use of pension fund surpluses.
- 57 The implications of the above are that:
- (a) Customers have benefited substantially from severance programmes which have been over and beyond what was assumed in setting price controls and which have been part-funded from the use of pension fund surpluses.
 - (b) Although Ofgem's proposals for rolling incentives will increase the incentives on companies to reduce operating costs, especially after the beginning of a price control period, such a mechanism has not existed in the past and, in NGC's case, the gulf between the benefits to customers and the benefit to companies of incremental severance programmes has been exacerbated by relatively short price control periods.

58

Combining (a) and (b), the implication of Ofgem's proposed Guideline 7 would be to penalise companies for taking actions which have benefited customers far more than they have benefited companies. This would seem intrinsically perverse, as well as (for the reasons given above) inconsistent with the stance taken up to now by Ofgem and its predecessors.

59

Overall, Guideline 7 would seem to make little sense as a guide to looking back over companies' past behaviour. If Ofgem wishes now to break with its past stance and state that **future** use of pension fund surpluses to part-fund severance programmes will be penalised, then that would signal clearly to companies what are the regulatory rules on this issue and would indeed be underpinned, in part, by the proposal to move to a rolling mechanism for the retention of the benefits of out-performance against price control assumptions.

National Grid Transco
22 August 2003



Attachment 2

Response on other issues

- 1 As foreshadowed in the previous consultation paper, Ofgem is proposing to change the operation of network price controls in a number of areas. These include:
 - (a) rolling incentives for out-performance against operating cost assumptions in price controls;
 - (b) mechanisms to both incentivise out-performance against capital expenditure assumptions, along with mechanisms for dealing with over-spending against those same assumptions;
 - (c) RAB treatment of non-operational capex;
 - (d) RAB treatment of asset disposals;
 - (e) treatment of tax in setting price controls; and
 - (f) timing of the next (TO) transmission price control reviews.
- 2 Our response on each of these issues is set out below.

Rolling incentives for opex out-performance

- 3 Ofgem recognises that the way that energy network price controls have operated in the past distorts the incentive to achieve opex reductions as between the earlier and later parts of a price control period. To counter this distortion, it suggests that companies should retain opex efficiency savings for five years, regardless of when the savings are achieved.
- 4 We agree with Ofgem's conclusion - the proposal would substantially reduce the identified distortion. We also agree that the proposed mechanism should roll from the current financial year. However, we would also make the following additional comments:
 - (a) Ofgem has, thus far, been less explicit than, for example, Ofwat in specifying precisely how the retention mechanism would work. We think that there is merit in broadly following the methodology set out by Ofwat in its MD187 document, published in June of this year.
 - (b) Ofgem does not address the issue of how it proposes to avoid offsetting the incentives of longer retention of achieved late-period savings by responding to big achieved savings by making a tougher assumption on the scope for **future** efficiency savings than would have otherwise been the case. There is no obvious way of avoiding this problem other than by having a mechanism which rolls on continuously without price review intervention - and we think that there are other arguments against such a mechanism, many of them implicit in Ofgem's discussion of how to deal with uncertainty when setting price controls. However, Ofgem could reduce the problem by explicitly deriving its price control proposals from detailed bottom-up analysis of operating costs, the reasonableness of which is easier to assess than sweeping top-down assumptions.

- (c) The principle of avoiding distortions should also be applied to SO activities, as well as to TO activities. In particular, consideration should be given to removing the present distortion between opex reductions achieved in respect of TO and SO activities

Capex incentivisation and remuneration

- 5 Ofgem's proposals on capex incentivisation are less clear than those for opex. In particular:
 - (a) Ofgem is proposing (in the section 'Distortions of incentives between opex and capex') that capex should be subject to broadly the same regime as opex – encouraging companies to spend less than assumed in a price control through five-year retention of the benefits of out-performance.
 - (b) In the section on 'Incentives to invest', Ofgem is proposing that there might be various mechanisms for dealing with cases where companies are required to incur more capital expenditure than was anticipated when the price control was set.
- 6 The combined effect of these two proposals could be that, for example:
 - (a) A company achieves £100 million of capex efficiencies during a price control period but has to spend £100 million, over and beyond what was anticipated when the price control was set, to meet new obligations or demands.
 - (b) The company could potentially, on Ofgem's proposals, receive no benefit from the capital efficiencies because its total capital expenditure has been exactly equal to what was assumed in setting the price control.
- 7 In principle, this problem could be resolved by the use of 'revenue drivers' which would uplift the price control by amounts more or less appropriate for the change in capex requirements from that assumed when setting the price control. Such an approach is broadly embodied in Transco's 'Deep SO' incentives and, very much more crudely, in the G_t term in the NGC TO price control and in the throughput term in Transco's LDZ price control. However, Ofgem's own proposals for the next DNO price control, which include the suggestion of some combination of revenue drivers and partial cost pass-through, suggest that Ofgem itself does not believe that the revenue driver approach will adequately deal with changes in capex requirements in all cases.
- 8 What the above suggests to us is that at least a necessary condition for Ofgem to implement the proposed incentivisation of capital efficiency (i.e. retention of the benefits of under-spend against regulatory assumptions for five years) is that adequate revenue drivers exist in the price control formula in respect of unanticipated changes in investment requirements. In the **absence** of adequate drivers, and given Ofgem's admission (para 3.37) of the lack of "full range of output measures", there is a risk that the proposed capex incentive would have similar properties to companies' existing incentives which favour under-delivery on capital programmes. This risk is heightened by the fact that the practical consequences of capex under-delivery may take time to materialise and take considerable time to correct (whereas the consequences of opex under-spend tend to manifest themselves relatively quickly and typically take less time to correct).
- 9 In NGC's case, for example, simply adding a five year rolling incentive to reduce capex onto the existing price control would increase the financial incentive to reduce investment in the transmission network at a time when NGC faces various pressures for increased capital spend, not least to support the development of renewable

generation. Such a mechanism would therefore reduce alignment between NGC's financial incentives and its underlying licence obligations to develop an efficient transmission system. A revenue driver based on the zonal boundary flows incorporated into Ofgem's final proposals for NGC's current TO price control could mitigate this situation, although a combination of revenue drivers and partial pass-through, as suggested in Ofgem's initial consultation paper for the Distribution Price Control Review, might offer a more complete way forward. However, to the extent that revenue drivers alone are inadequate, then (as suggested in para 8 above) the justification for having rolling incentives to reduce capital expenditure would be weakened.

- 10 Either way, we agree with Ofgem's suggestion that new ways be found to remunerate capital expenditure which is not anticipated when price reviews are set. It is particularly important both that:

- (a) companies have reassurance that efficiently incurred capex will enter the RAB; and
- (b) a reasonable return is earned in respect of the period between when the capex is incurred and when it enters the RAB.

RAB treatment of non-operational capex

- 11 We welcome the proposal to capitalise all types of non-operational capex and agree with the proposition to assume a generic regulatory life for all such expenditure. In our view, that life should be around 5 years.
- 12 Ofgem suggests that it is important not to create distortions in relation to other categories of capex but it is at least arguable that the key requirement for consistency is between the treatment of non-operational capex and **opex**, rather than with other types of capex. However, we agree with the proposition that benefits of any efficiency savings on non-operational capex should be retained for a fixed period of time.

RAB treatment of disposals

- 13 Ofgem proposes that regulated asset disposals are deducted from the RAB five years after the year of disposal, consistent with the rolling capex mechanism. We welcome this proposal which would remove the periodicity of the incentive to dispose of assets across the review period. However, there is considerable variation of regulatory depreciation period across networks, ranging from 45 years for Transco to 20 years for certain DNOs, and to a lesser extent cost of capital allowances from 6.25% to 6.5%. Consequently, the proposed mechanism would provide varying levels of incentives as between Transco, NGC and the DNOs (as well as between the DNOs themselves) to dispose of assets.
- 14 Any such variation of incentives between companies seems unjustified and we would propose that the proportion of benefits to be retained by the regulated businesses should be standardised. More specifically, we believe that Ofgem should consider adopting a similar approach to that employed by Ofwat in relation to disposals of protected land by the water and sewerage companies and the water only companies. The net proceeds of any asset disposal could be shared 50:50 with customers by adjusting the RAB at the time of the next price control. In determining the size of the RAB adjustment, the customers' share would be uplifted by the relevant cost of capital up to the end of the relevant price control period.
- 15 The benefits of this approach are that it would be relatively simple to administer, would allow for consistent incentives to apply to each regulated company and, as with Ofgem's suggested approach, would not be subject to periodicity effects.

Price control treatment of tax

- 16 Ofgem and its predecessors have always looked at the expected tax position of the energy network companies when modelling the overall financial position of the companies. However, in the past the 'primary' rate of return calculation has been undertaken on a pre-tax basis, using a standard tax 'wedge', based on the Corporation Tax rate.
- 17 Ofgem is now proposing that it may use company-specific tax rates in undertaking its primary calculation, partly on the grounds that some companies may, in future, incur tax rates well in excess of the corporation tax rate and partly to weaken the incentive on companies to increase their gearing. By implication, company-specific tax rates would only be used if the expected tax rates for those companies were either significantly higher than the Corporation Tax rate (due, not least, to the impact of changes in Corporation Tax allowances) or significantly lower (due to, for example, relatively high gearing).
- 18 Where a network business's actual tax rate is likely to be materially in excess of the Corporation Tax rate, we support, in principle, the use of an ex ante company specific tax rate. This would take account of relevant efficient costs which the business is likely to incur, while leaving the business with a continuing incentive to manage its tax affairs efficiently.
- 19 We also agree that there should be symmetry between the regulatory treatment of tax efficiencies and other types of operating efficiencies.
- 20 Either way, the relevant company-specific tax rate should be for the regulated business as a stand-alone business. Otherwise, there is a risk that regulation could itself distort decision making, not least with respect to company structure.

Timing of next (TO) transmission price control reviews

- 21 Ofgem is currently proposing that the Scottish transmission price controls should be reviewed at the same time as the NGC TO price control. Ofgem also acknowledges that there may also be a case for aligning the TO price reviews for gas and electricity transmission. Given these two, and potentially conflicting sets of considerations, and given Ofgem's proposal to conduct the electricity transmission reviews at the same time, Ofgem has effectively floated the following three alternatives for the various reviews:
- (a) conduct the electricity transmission reviews between 2004 and 2005 and leave the Transco TO review until 2005 to 2006. Ofgem implies that workload considerations would favour this option;
 - (b) delay the Scottish transmission reviews by two years (from the status quo) and the NGC TO review by one year – which would have the effect of all the transmission price reviews taking place between 2005 and 2006; and
 - (c) delay the Scottish transmission reviews by one year and bringing forward the Transco review by one year – which would have the effect of all of the reviews taking place between 2004 and 2005.
- 22 Our views are that:
- (a) Offer previously concluded that Scottish transmission and distribution price controls should be conducted simultaneously because of the extent of shared costs and operational integration between Scottish distribution and Scottish

transmission. Ofgem's current proposals imply that shared costs within the Scottish companies will now be examined twice within either two or three years.

- (b) Ofgem has previously concluded, in the last NGC TO review, that little useful comparative information was gained from comparing Scottish transmission and NGC transmission operating costs. This was partly because of the differences between the respective systems and partly, at least by implication, because much of Scottish transmission costs are allocated from a broader integrated operation. These points would still seem to us to be valid.
- (c) On the basis of (a) and (b) above, the case for conducting NGC and Scottish transmission reviews together, and at a different time from reviewing Scottish distribution costs, would seem unproven. The BETTA dimension, which largely concerns SO incentives, does not seem to bear very much on this core argument.
- (d) The workload case against conducting the gas and electricity transmission reviews at the same time would not seem to us as straightforward as Ofgem implies. Delaying the NGC review by one would create a bigger workload in 2006 (through the coincidence of the NGC and gas reviews) but would lead to a smaller workload in 2004 (because of avoiding the NGC review overlapping with the DNO review). Either way, 2005 would be a busy year. Workload considerations alone would seem to rule out only the option in which the Transco review is brought forward one year – which would unambiguously increase peak demands on Ofgem.
- (e) The case against bringing forward the Transco review by one year is further reinforced by the general undesirability, on incentive grounds, of shortening price control periods.
- (f) Overall, we think that the case for delaying the NGC price review by one year, and for conducting the NGC and Transco reviews simultaneously is compelling, regardless of what is done with respect to the Scottish transmission reviews. This is because:
 - (i) It would save costs, not least for Ofgem, because of the need to examine NGC-Transco shared costs once, rather than twice.
 - (ii) Incentives for NGC would be improved through not having the pool of shared costs examined again, one year after its price controls has been set.
 - (iii) It is not obvious that delaying the NGC review by one year would have much of an impact on the peakiness of Ofgem's workload, albeit that the peak would occur at a different time

