Summary of responses

This Appendix sets out a detailed summary of responses to June/July documents.

Respondents to the June and July consultation documents

DNOs

1. Aquila Networks plc
2. EME Distribution plc
3. EDF Energy plc
4. Scottish & Southern Energy plc
5. Scottish Power
6. United Utilities plc
7. Western Power Distribution
8. YEDL & NEDL (CE Electric UK Funding Company)

Others.

1. BOC Gas Process Solutions
2. British Gas Trading
3. British Hydro Power Association
4. The British Wind Energy Association
5. The Broads Society
6. Campaign to Protect Rural England - Gloucestershire
7. Campaign to Protect Rural England – Shropshire
8. Campaign to Protect Rural England - Wiltshire
9. Centrica
10. Council for National Parks
11. The Countryside Agency
12. Corporation of London
13. CPRE
14. CPRE – Friends of the Lake District
15. Eryri – Snowdonia Society
16. Exmoor Society
17. Friends of the Lake District
18. GMB
19. Hymans Roberston
20. Lancashire County Council
21. National Grid Transco
22. National Economic Research Associates
23. The Northumberland and Newcastle Society
24. Prospect
25. Ralph Turvey
26. Renewable Power Association
27. Revolt
27. Scottish Renewables Forum Limited

Policy issues

Ofgem's statutory objectives and those of the licence holders

Several respondents argued that Ofgem and DNOs need to recognise and refer to their statutory duties towards the environment under Electricity Act, Environment Act and the Countryside and Rights of Way Act duties, in particular in relation to National Parks and Areas of Outstanding Natural Beauty (AONBs). It was argued that emphasis on achieving cost efficiency above other goals will not necessarily produce a service that also provides environmental benefits and that ensuring that DNO's networks protect and enhance the natural environment is a fundamental part of providing a quality service and that it should be possible to reflect this in charges to customers.

It was also argued by several respondents that Ofgem should include environmental performance in output measures, such as targets for placing overhead lines underground within designated areas such as AONBs and National Parks.

Structure of the existing price controls

There was broad agreement that RPI-X regulation has worked well so far and that the present structure for the price control remains appropriate. However, one respondent was concerned that the structure of the price control is becoming increasingly complex with the associated reporting burden growing. Another respondent stressed that the price control should be flexible enough to address the need to invest.

One respondent argued that there should be more output related incentives to ensure that future efficiency savings are real and not illusory.

There was also broad agreement that five years remains an appropriate price control duration.

Network rates

One respondent argued that DNOs can to a certain extent forecast and influence the level of business rates and NGT exit charges and that therefore there should be some limited incentive on DNOs to ensure that those costs are at an appropriately efficient level.

Licence fees

It was argued that given that DNOs have no real influence on the level of licence fees, a continuation of pass through for these costs would be appropriate.

Distribution losses

One respondent argued that the current losses incentive appears to have little or no effect on DNOs' behaviour and that the current losses incentive requires significant strengthening with respect to technical losses.

Revenue drivers

There were several suggestions how the current revenue drivers could be improved. Many respondents, although not all, agreed that there was a need to change the revenue driver, especially in relation to DG. Some respondents argued that some form of capacity driver might be appropriate. Several respondents argued that the revenue driver should be based on actual rather than projected number of customers. It was also argued that changes to the revenue driver should be seen in the context of how opex and capex revenues are taken into account in order to ensure a consistent approach.

Scope of the price controls

EHV charges

In their responses, the DNOs argued that EHV charges should remain excluded given the special characteristics of EHV supplies. However, it was also suggested that it may be appropriate to introduce a limited number of additional or revised performance standards in respect of non-contestable connections work. Another respondent argued that EHV customers are protected by the right to request Ofgem to determine charges in the case of a dispute with the DNO.

However, one other respondent argued that EHV charges should be within the scope of the price control, given that EHV services are provided by monopoly providers and that therefore EHV customers should enjoy the same level of protection as HV and LV customers.

Wheeling charges

One respondent argued that excluding wheeling charges from the price control could discourage companies from using neighbouring networks when it is efficient to do so. It was suggested that by treating wheeling charges as pass-through costs in a similar way to transmission exit charges this could be addressed.

Other services

Several respondents argued that it was desirable to clarify rules around excluded services. For example, it was argued that when DNOs become more active in managing generation connected to their networks this would give rise to a new class of excluded services.

Several respondents argued that Ofgem should allow electricity distribution companies to increase their expenditure on undergrounding through the price control.

Network resilience

One respondent argued that network resilience should be part of the core price control. Another respondent argued that customer expectations have changed with regard to the underlying integrity and security of network assets. Investment incentives are needed. Incentives need to strike a balance between the interests of current and future customers. It was argued that this requires stronger incentives than present and a more stable and certain framework.

Competition in connections

Several respondents argued that the interests of customers are best served by the continuation of the existing regime as this provides adequate safeguards through the existing licence conditions and Competition Law. It was argued that connections is a competitive activity with many connections providers active in the market and with customers being further protected by the right to request a determination of charges from Ofgem in the event of a dispute.

However, there was some support for the introduction of appropriate performance measures and standards. One respondent argued that Ofgem should be more prescriptive with respect to tariff structures rather than leaving matter of design to individual DNOs.

Duration of the price controls

There was broad support for continuation of a five year price control period.

Fixed retention period for efficiency savings

There was wide support for Ofgem's proposed fixed retention period for opex and capex savings in order to remove periodicity distortions. However, respondents asked for more clarity of how such a system would work in practice. One respondent raised concerns relating to how such a system would interact with capex overspend, as in practice it could result in overspend offsetting the efficiency savings with the company not benefiting because total capex is equal to what was anticipated when price control was set.

It was argued that the issue was not just periodicity but also the strength of the incentive. Several respondents raised concerns relating to the treatment of opex savings compared with capex savings, it was argued incentives could be aligned through ensuring that the proportion of the efficiency saving retained by a company is the same through setting of different retention periods or using a multiplier adjustment (as proposed by Ofwat).

Several respondents argued that future efficiency gains will require greater effort and innovation and many initiatives will require upfront expenditure. Several DNOs argued that the current sharing of efficiency gains might not be optimal. It was argued that the benefit to customers from cost savings initiatives is maximised if the share retained by the network company is at least a half and that once the easiest efficiency initiatives are accomplished, the proportion of the benefit retained by the DNO needs to rise.

One respondent argued that consistency in treating capex and opex could be achieved by de-coupling capex savings from the RAV and capturing them in a regulatory reserve. These savings would be returned to customers after a pre-specified period of time. OPEX savings are also captured in the regulatory reserve and returned over the same period of time.

Another respondent pointed out that it might be difficult to distinguish between genuine efficiency savings and savings resulting from deferring investment projects, given that a large part of DNO capex is merely a *forecast* of the cost of what is needed to meet *forecasted* outputs hence a divergence between the two might not just be caused by efficiency savings but could reflect poor forecasting.

Improving the incentive and price control framework

It was argued that greater clarity in the area of assessment and treatment of over/underspend including the link to outputs was needed to promote confidence that sound management decisions would not be penalised, and to prevent weakening of incentives due to uncertainty.

Dealing with uncertainty (June doc)

There was wide support for the use of a decision making framework. Several DNOs argued that more formal arrangements should be introduced to reduce risk for both equity and debt providers as applied in the Water industry. It was also argued that where unforeseen/unquantifiable costs are outside the control of companies they should be passed through to customers. However, some respondents were disappointed with the lack of progress on developing the uncertainty framework. It was argued that the framework is theoretical and raises many questions with respect to practical application. Ofgem was urged to set out clear rules for dealing with cost increases, including:

- circumstances under which mechanisms will be applied;
- circumstances under which pass-through will be appropriate and those under which efficiency tests will be applied; and
- criteria that will be used to assess efficiency.

Incentives to invest (June doc) and treatment of overspend

It was argued that given the uncertainty surrounding CAPEX forecasts, CAPEX allowances should not be considered as an absolute maximum. The view was that under the current regime companies are unlikely to undertake discretionary CAPEX and that new ways to deal with overspend have to be developed so that companies have reassurance that efficiently incurred capex will end up in RAV and a reasonable return is earned with respect to the period the capex is incurred and entered in the RAV. It was argued that more clarity on how overspend is treated is needed, i.e. clear and transparent criteria for what would be included in the RAV.

Several respondents argued that significant changes of CAPEX should be dealt with as an interim adjustment to the price control whereas minor changes should with prior regulatory agreement be logged up for recovery via the next price control.

It was also argued that the application of 'used and useful' test to determine whether a company receives higher/lower rate of return will encourage speculative behaviour or excessive caution.

Non-operational capex

There was broad support for Ofgem's proposal to capitalise all types of non-operational capex and to assume a generic regulatory life for this. However, there was concern on how Ofgem would assess whether expenditure was efficient. It was argued that 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 standard. Hence, it was argued that there is a need for clear and objective criteria and procedures for disallowing expenditure that is demonstrably inefficient or imprudent.

One respondent argued that including non-operational capex into the RAV would introduce practical complexity in calculating the RAV and that it would therefore be preferable to adopt an approach based on costs being expensed and dealt with alongside operating costs.

Quality of service and other outputs

Scope of the output measures

Three respondents supported the view that outputs should be based on measures needed to protect consumers' interests, and that these should be informed by research on consumer preferences. Five respondents did not approve the extension of the existing output measures to include environmental areas, whilst two considered this extension appropriate. One respondent in favour of this extension quoted Ofgem and DNO statutory duties under the Electricity Act, Environment Act and Countryside &

Rights of Way Act as justification. Two respondents were of the view that if the measures were to be extended, the new output measures would have to be under control of management, they would have to be measurable and Ofgem would have to allow for the costs that would have to be allocated towards their achievement.

Three DNOs were in favour of schemes to incentivise network resilience and performance following severe weather. One DNO considered that there are practical difficulties in devising a scheme which would be responsive to storm severity but fair to both companies and consumers. One respondent considered that the risk of adverse publicity was sufficient incentive on DNOs to perform during severe weather conditions.

Three respondents commented that new incentives do not necessarily have to be financially driven; one suggested that measures should be introduced as 'reportable statistics', whilst another proposed a form of public reporting through performance tables. One commented that non-financial incentives are best applied where the output is difficult to measure in an objective manner.

Form of the incentive scheme, targets and incentives

One respondent commented that financial incentives need to be symmetrical, thereby offering the same levels of reward for over-performance as penalty levels for underperformance. Three respondents noted the need for consistency between the expectations of improved performance and the proposed expenditure levels necessary to achieve such improvements.

Opinion was split on the treatment of planned interruptions and incentives. Two DNOs considered that planned interruptions should be excluded from the IIP scheme, three other respondents thought that planned interruptions should remain within the IIP scheme and one respondent commented that the treatment of planned interruptions needed further consideration. One respondent in favour of retaining planned interruptions within the IIP proposed that the financial exposure of DNOs for planned interruptions should be less than that for an unplanned interruption.

Development of the GOSPs

There was agreement amongst respondents that the level of GOSPs and associated compensation needed to be tied to investment allowances and customer willingness to pay. Respondents also considered that a review of the framework may be useful in eliminating duplication, such as overlap with IIP. The majority were against the inclusion of OSs in IIP. Respondents still considered that the cost of instigating automatic payments was prohibitively great when compared with the benefits.

Consumer research

There was broad support for the work being undertaken on consumer preferences. One respondent considered that phase two should include the views of suppliers as well as consumers. One DNO was of the opinion that there should be no leading questions on issues such as under-grounding of cables, whilst a large number of respondents associated with environmental organisations stated that there should be specific questions on consumers' willingness to pay for under-grounding of cables.

Comparing quality of supply performance

Respondents recognised the relevance of this area of work, but some expressed concerns that the results would be applied in a mechanistic way, rather than being used to inform the general overview of each company's performance. One DNO was concerned that the reliance on one year's data may be misleading, and questioned the robustness of the methodology being employed. Two respondents considered that region-specific characteristics would make it difficult to obtain reliable comparisons.

Rewarding frontier performance

There was a variety of views in relation to assessment of frontier performance. Two considered that this should be based on the rate of improvement since the audited figures in 2001/02, whilst one considered that this would be problematic. One DNO questioned what was meant by 'frontier performance', whereas another thought that this assessment should be based on value-for-money rather than specific output criteria. Two DNOs advocated that frontier companies should be rewarded by being set less onerous performance improvement targets from 2005 onwards.

Treatment of exceptional events

A number of respondents highlighted the need for a clearer definition of 'exceptional event' and considered that it would impose unacceptable risk on companies to remove this exemption. One DNO that supported the removal of the exemption and the introduction of automatic compensation noted that companies would have to be recompensed accordingly.

Forecast Business Plan Questionnaire (BPQ)

Respondents agreed on the need for this work and were looking forward to engaging Ofgem on discussions regarding the scenarios to be planned.

Incentives for the speed and quality of telephone response

Two respondents voiced concerns over the use of comparative regimes, considering it may encourage spending on answering systems that were not in line with customer willingness-to–pay. There was general support for the intention to assess the effectiveness of automated customer answering systems.

Distributed generation

Implications of the revised distribution charging structure

There was a general consensus that the costs associated with DG should be shared amongst all customers on a GB-wide basis, rather than carried by those regions with the greatest concentrations of natural resources, as all customers would receive environmental benefit. One respondent stated that consumer willingness to pay for such work should be explored. Some respondents noted that any changes to the current systems should not create perverse incentives for preferential connection to either of the transmission or distribution networks, nor that it should create preference for DG work over more appropriate projects.

Incentives for network access and investment

The majority of respondents welcomed the idea of a hybrid cost driver, although one respondent considered that a £/MW driver was not appropriate at this time due to the lack of data on DG costs. Most other respondents also recognised the difficulty involved in calculating a robust figure for the £/MW driver, given the range of factors to be considered in establishing this figure. Several respondents considered that the pass-through rate should be at least equal to WACC, and one respondent suggest that where this is not the case, the DNO should have the right to refuse connection. DNOs considered that a premium rate was required to compensate for the risk of stranded assets (in the event that connected DG stops generating) and the costs associated with adapting networks from passive to active load management. One respondent noted that some generation has output significantly less than 1MW and that the revenue driver should not act as a disincentive for such DG. Respondents also asked for clarification as to how Ofgem intended to treat DG investments for the purpose of the RAB.

Incentives for network operation

Two respondents agreed with the June 2003 document's view that due to the differences between the transmission and distribution networks, it was not appropriate to introduce transmission-type incentives for distribution networks. The majority of respondents noted the difficulty associated with obtaining a robust measure of network availability and two noted that generators should have the opportunity for adopting a variety of cost/availability options. Most respondents preferred a £/MW driver in preference to a £/MWh driver on the basis that the latter exposed the DNO to the competitiveness of the generator and it would create a bias towards the adoption of high-load factor generation technologies.

Additional mechanisms

There was widespread support for the concept of RPZs, though one respondent was doubtful that RPZs and IFI would result in a significant improvement to the amount of DG connected.

Assessing costs

There was general support for Ofgem's stated approach for assessing efficiency and projecting future costs. However, DNOs were concerned that the use of 'best of class' costs across all categories would lead to an unrealistic cost base. Reservations were also expressed about Ofgem's policy on mergers. Some respondents proposed basing costs on an average company, so as to provide better incentives for out-performance.

Description of DNOs' costs

One DNO considered that the list of cost drivers was incomplete and should be updated when the Historical BPQ responses are received. Another respondent expressed concern that environmental and amenity enhancement works were not referenced in the list of cost drivers.

Changes in costs

A respondent noted that Ofgem indicated that DNOs are substantially out-performing opex and capex allowances and believed that this should be considered by Ofgem when establishing the forthcoming price controls.

Assessing costs at the last price control review

There were mixed views on the merits of the cost assessment conducted for the last price control review. One respondent stated that regression analysis of opex produced a robust assessment of the relative performance of DNOs. However, both this respondent and another respondent considered that the projection of costs on an 'average' company, as opposed to a 'frontier' company, provided better incentives to encourage out-performance. It was also stated that the use of 'glide path' methodology further reduced incentives for 'frontier' companies and in effect rewarded laggards. A further respondent considered that the continued use of the 'frontier' company approach to set revenues may threaten the sustainability of the sector by driving all companies to unreasonably low cost levels.

One respondent considered that the cost assessment conducted for the last price control review had a number of flaws, including poor transparency and methodology.

Proposed approach to assessing costs

There was general support for Ofgem's statement that it will use a range of techniques for assessing efficiency and projecting future costs. Ofgem's approach to assessing fault costs on a total cost basis and the use of bottom-up modelling for opex and capex was supported by the majority of respondents who commented on these issues. However, one respondent was concerned that the analysis on total cost basis might lead to undue clustering of DNO relative efficiency scores. The same respondent considered the techniques used in previous price controls were robust and that the adjustment mechanisms to achieve comparability are well understood. Several of the respondents highlighted the importance of process transparency so that DNOs would be able to understand the analysis performed and the consequent conclusions. Three DNOs commented on the problems related to the comparatively small number of data sets available and the importance of ensuring their comparability. Two respondents commented that drivers of future costs may not all be apparent from a review of historic costs.

One respondent welcomed Ofgem's intention to evaluate DNOs on the basis of eight separate management teams and merged organisations in addition to evaluating the 14 individual businesses. Another considered that Ofgem should take account of the economies of scale (and the corresponding apportionment of fixed costs) that have been realised from mergers, so that sole DNOs are not discriminated against. Five respondents expressed reservations about Ofgem's policy on mergers. These respondents considered that merger savings should not be treated any differently from normal efficiency savings, and that rather than these savings being anticipated, they should only be taken into account after a reasonable period in which the benefits are enjoyed by the DNO. They also highlighted the risk that merger savings may be double counted through revenue reduction and an immediate recognition of merger efficiencies. One of these respondents considered the assumption that a merged company would reach the efficiency frontier within five years of the merger to be invalid, on the basis that there are now more merged companies than stand-alone companies.

Review of actual costs

There was a common concern amongst the majority of respondents that the use of 'best of class' costs across all cost categories (for both opex and capex) would lead to an unattainable cost base. The use of total cost modelling was generally proposed as a means of providing a safeguard against such an outcome, whilst recognising the difficulty in applying this technique. Another theme amongst respondents was the issue of inconsistency of data definitions, cost allocations and capitalisation policies, which could lead to invalid conclusions if left unresolved. One respondent reiterated the point about the sample size limitations of the data sets, which could lead to significant sampling errors. Another respondent considered that more effort needed to be directed towards the determination of appropriate glide paths for future cost bases.

Review of forecast costs

Several DNOs expressed reservations about the use of Total Factor Productivity ('TFP') analysis by Ofgem. Two considered it inappropriate to use TFP to set DNO specific targets, but thought it could be used to inform decisions on industry-wide movements in costs. A further two DNOs cautioned against using past productivity improvements as an indicator of future potential performance gains, and two others considered that the results of TFP analysis needed careful interpretation.

Information sources

Respondents were generally supportive of the concept behind the Asset Risk Management ('ARM') survey, with one suggesting it should be used to test the credibility of investment plans. Two respondents cautioned that the ARM data must be interpreted in conjunction with a DNO's specific investment plans, and that it would be inappropriate for use as a benchmark to determine the efficient costs of other companies.

Financial issues

Obligations with respect to financing of companies

DNOs asked for Ofgem to clarify what credit rating it regards as being comfortably within investment grade. Several DNOs interpreted this as a stable A- credit rating.

Ringfencing

The general view was that the current ringfence provisions do not need strengthening. It was argued that present arrangements do allow Ofgem to step in when problems arise to enhance the ring-fence in the light of the specific areas of concern.

Special Administration

It was argued that given the nature of the DNOs' obligations there is a case for a special administration regime to cover the extreme case of a financial failure. One respondent stated that the Shipwreck clause in water licensing is a potential model to deal with circumstances outside firm's control. It was also argued that statutory change to bring in Special Administration should be accompanied by licence modification to ensure that companies are protected from events beyond their control. Some respondents were concerned that the introduction of a Special Administration regime could increase the market perception of regulatory risk and increase the cost of borrowing. One respondent argued that the cost of a Special Administration regime should not be borne by companies.

The cost of capital

Capital Asset Pricing Model

There was broad support for the continued use of CAPM to estimate the cost of capital and to adopt a forward-looking approach. It was also argued that given the uncertainties surrounding this review and future investment incentives, the cost of capital should not be set 'too low'. It was also argued that the use of a return on equity approach may provide some degree of protection to companies, given that equity returns have been relatively stable over the last 10 years or so.

Tax

It was pointed out that the new tax treatment of non-load related CAPEX from April 2005 would lead to a significant increase in the effective tax rate of companies.

However, respondents were divided whether Ofgem should adopt a post-tax or pre-tax approach to the cost of capital. Several respondents supported the move to a post-tax cost of capital, based on a company specific tax, as this would provide an incentive for firms not to gear too highly. Other respondents argued that a pre-tax WACC was more appropriate as this would provide incentives for companies to finance themselves efficiently, whereas a post tax approach would inappropriately claw-back the benefit of increased gearing and other mechanisms (e.g. leasing).

Embedded debt

Several respondents argued that Ofgem should allow for embedded debt where distributors used fixed rate long-term debt as part of an historic efficient financing portfolio. There was concern that using forward looking estimates would exacerbate the embedded debt problem.

Assumptions on gearing

Respondents welcomed a common assumption on gearing for estimating the allowed cost of capital. However, one respondent argued that this would not be consistent with the use of company specific allowances for tax liabilities. Another respondent argued that the assumed gearing should be around 50% to avoid companies being forced to move to thin equity structures.

Range for the cost of capital

One respondent noted that an Oxera report published in October 2002 (on behalf of the Electricity Association) argued for an equity risk premium of greater than the 3.5% used in the current review, on the basis that there is a greater forward-looking stock market volatility.

Assessing the RAV and the approach to depreciation

Two respondents considered that a 20 year post-vesting asset life, as used in the current price control, should be continued for the forthcoming price control. Two other respondents indicated that the use of repex capex should only be considered after other options had been explored. Two respondents supported Ofgem's statement on adjusting the RAV to deduct the disposal proceeds received from the sale of assets five years after the year in which the disposal was made, and one further respondent noted that this should only apply to assets used in the regulated business.

Treatment of pension fund costs

General

Most respondents welcomed the proposal to provide a clear framework for the treatment of pension costs in setting price controls. There was also general support for the view that price controls should fund the future costs of providing a competitive package of pay and benefits including pensions. Trade union respondents welcomed Ofgem's recognition of the need for companies to be able to recruit and retain appropriately qualified staff.

Several respondents argued that it was inappropriate to consider pension costs retrospectively as retrospection is a generally unsound basis of regulation and previous price control settlements should be allowed to stand even where in hindsight it might be apparent that errors had been made. They argued that to do otherwise would introduce an unacceptable degree of uncertainty.

Among the network monopolies who responded, most argued that pension costs should simply be a pass-through item, unless they result from imprudent management action. They also indicated that Ofgem must set out in detail how the principles are to be applied, and clarify what in its view represents 'current best practice' in the estimation of pension costs.

Most respondents argued that full regard must be given to the Protected Persons Regulations[1] (which entrench the pension rights of persons who were members of the industry schemes at privatisation). It was pointed out that the effect of the Regulations is to make the benefit entitlements of protected persons a legal obligation of the relevant Successor Company (within the meaning of EA 89) and its successors in law, regardless of where qualifying service was performed.

The network monopolies raised arguments relating to the principles on under-funding, regulated-unregulated split and benefit enhancement arising from re-organisation and /or redundancy.

Underfunding

Companies argued that it is unclear whether any allowance was made in past price controls for pension costs. Companies argued that opex allowances at the 1999 review were set on the basis of the base-year costs of the frontier companies, at least one of which had a complete contributions holiday in that year. Accordingly, it would not be appropriate to assume customers had paid implicit amounts equal to companies' accounting charges.

Regulated-unregulated split

Most DNOs argued that, at least in respect of the period prior to the separate licensing of distribution and supply activities, all Public Electricity Supplier (PES) employment was related to the discharge of statutory duties (i.e. the duties to supply and to develop and maintain an efficient, co-ordinated and economical system for the distribution of electricity). Accordingly, all pension costs attributable to this employment (or, at least, all costs attributable to employees who retired prior to October 2000 and those who continued to be employed in the distribution business since then) should be recoverable

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[1] The Electricity (Protected Persons (England and Wales) Pension Regulations S.I 1990/346, The Electricity (Protected Persons) (Scotland) Pension Regulations S.I 1990/510 (S.68)

under the distribution price control, regardless of whether the company still carries on a supply business.

The companies argued that the cost of providing pensions to former employees of businesses no longer carried on by them will still have to be borne by the company which retains the legal obligation to provide the pension and by its present and future employees. Companies argued they will therefore have to recover future costs out of the revenues of the businesses they still carry on, even if this is only the regulated network business, and that accordingly all pension costs should be allowed for in price controls.

Companies argue that PES separation was forcibly imposed, not voluntarily undertaken, and was effected by Transfer Schemes approved by the Secretary of State. Companies argued that it was not possible to allocate pension liabilities by way of the transfer schemes, and that it would in any event not have been appropriate to burden the supply successor with historic liabilities that its competitors did not face.

NGT argued that neither Ofgem nor the MMC required allocation of pension liabilities at the time of the Centrica demerger. NGT also argued that the two subsequent price controls (Ofgas/MMC (1997), Ofgem (2001)) did not envisage any regulatory partitioning and arguably, on both occasions, the 'Centrica' element of surplus was used for the benefit of consumers. In NGT's view, it is therefore not reasonable to have regulatory partitioning going forward and in its view the only basis for applying Guideline 6[2] to the Centrica de-merger would be that the parties had behaved unreasonably at the time.

Benefit enhancement

Several DNOs stated that the principle is unacceptable. All DNOs argued that the rules of the ESPS[3] prescribe specified benefit enhancements in the case of members whose employment is terminated before normal retirement date as a result of reorganisation or

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[2] 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 (Electricity Distribution Price Control Review - Initial Consultation, July 2003, 68/03).

[3] Electricity Supply Pension Scheme

redundancy. As a result it is argued that the resulting early retirement deficiency costs are a legal obligation of the employer. It was also suggested that it is appropriate to defer deficiency payments where the Trustees are satisfied that the scheme has sufficient assets to meet its liabilities (as increased by the enhancement).