Electricity Distribution Price Control Review, Update October 2003

Response by National Grid Transco

1 Our response focuses on three issues covered in Ofgem's Update document:

(a) the proposed 5 year rolling incentive mechanism for operating costs;

(b) the regulation of capex, including both refinement of the existing incentive mechanism and the proposals for dealing with unanticipated requirements for capex, including in respect of distributed generation; and

(c) the proposals in respect of pension costs.

Opex incentive mechanism

2 The Update document confirms Ofgem's intention to allow rolling five year retention of the opex savings over and above those assumed when setting price controls. In addition, it is proposed that:

(a) Incremental savings before April 2003 will not be eligible for the proposed mechanism.

(b) For the period 2005-10, the opex incentive allowance will be constrained not to be negative in any year.

3 We agree that there is a case for not applying the mechanism retrospectively in that past behaviour is a bygone. However, it needs to be noted that the proposed mechanism has been under consideration by Ofgem for some time and that both this consideration and the use of the mechanism by Ofwat during the current water price control period gave companies reason to expect that some such mechanism **would** be introduced. To that extent, behaviour has been influenced by the **prospect** of the scheme being introduced and, also to that extent, it would be reasonable to include earlier years in the mechanism.

4 We are not clear how Ofgem's proposals to start the mechanism running from 2003/04 sit with the proposal that "Where companies fail to meet the allowed level of opex (i.e. they overspend or underperform), the overspend will be offset against any underspend for the five year period". What Ofgem seem to be proposing is that companies can get no positive incentive allowance in respect of the period 2000/01-2002/03 but can, in effect, get a negative allowance. This would not seem to be reasonable.

5 We agree with the proposal for the allowance to be constrained not to be negative for the period 2005/06-2009/10.

Capex incentive mechanism

6 Ofgem's Update paper deals with incentivisation and remuneration of capex across Chapters 3, 4 and 5. Unfortunately, it is not clear that these chapters are consistent with each other. In particular:

(a) Chapter 3 sets out proposals for making more concrete how companies will retain the benefits, for a rolling 5 year period, of capital underspending against price control assumptions. **The point of this mechanism is to encourage companies to spend <u>less</u> capital.** Implicitly, the mechanism assumes that:

(i) There are no unanticipated changes in the requirement for capex during the price control period. This is because, otherwise, Ofgem would not be able to distinguish between capital efficiencies and such unanticipated 'external' changes.

(ii) The relevant outputs of the assumed level of capex (i.e. the 'baseline' outputs) can be measured. This is because, otherwise, Ofgem would not be able to distinguish between efficient and inefficient underspend against price control assumptions.

(b) In contrast, Chapters 4 and 5 point in different directions. Specifically:

(i) Chapter 4 shows that capturing and measuring the outputs of network capex is very much an ongoing project.

(ii) Chapter 5 is all about how price controls should deal with unanticipated changes in capex requirements, specifically but not just in the context of requirements arising from distributed generation. **The point of Chapter 5 is about how companies can be encouraged to spend <u>more</u> capital in response to customer requirements.**

7 As a result, there would seem to be a disconnect between the Chapter 3 mechanism, which is all about giving higher powered incentives not to spend capital, and Chapter 5 which is all about encouraging companies to spend more capital when changing circumstances require it. As Ofgem have suggested in this current paper and elsewhere, the funding of unanticipated changes in capex requirements could be dealt with in a variety of (not mutually exclusive) ways, including:

(a) revenue drivers;

(b) interim determinations;

(c) pass-through of actual costs incurred within the price control period in which they are incurred; and

(d) cost recovery through the subsequent main price review, with this latter option breaking down into various sub-variants with respect to:

(i) the degree of assurance which companies have, when the spend is being contemplated, that they will get the relevant spend into their regulatory asset bases in due course; and

(ii) the extent to which they will recover depreciation and return on the relevant investments in respect of the period between when the costs are incurred and the start of the next price control period.

8 However, the existence of this armoury of techniques for dealing with unanticipated capex requirements does not itself solve the problem of the **interaction** between, on the one hand, solutions to this problem and, on the other hand, the rolling incentive to reduce capex. With the exception of some hypothetical adequate revenue driver, all the other methods involve Ofgem making judgements about whether particular capex

falls into the box which is covered by price control assumptions or into the box which covers unanticipated capex requirements.

9 Against this background, we think that Ofgem should question whether rolling capex incentives are an appropriate part of overall capex incentivisation, at least until there is better resolution of how to deal with unanticipated capex requirements to spend capital. There is a risk in the way that Ofgem has framed its proposals that rolling incentives will be adopted on the assumption that other issues can be resolved – when it is not currently clear that they will be resolved in the near future and when their non-resolution would, in our view, undermine the rationale for rolling incentives.

10 Against this background, and in the absence of an adequate 'mechanical' solution to the capex uncertainty problem (e.g. via an adequate revenue driver or drivers), our view would be that a more fruitful way forward would be to:

(a) Recognise that the world we are now in is one in which there is significant uncertainty about future network capex requirements (and not only in relation to distributed generation).

(b) Recognise that, despite this uncertainty, the general bias will be to unexpected changes requiring more capex than was previously anticipated, rather than less.

(c) As now, make the best possible estimate of future (5 year) capex requirements at a periodic review.

(d) Have interim determinations if there are **major** changes in capex requirements during a price control period (as with, for example, the potential increased requirement for transmission capex to facilitate the development of renewable generation in remote locations).

(e) In any event, assure companies that any overspend (against price control assumptions), **if judged by Ofgem at the next price review to have been efficiently incurred**, will be recoverable in full in the next price control period. In other words, recovery would include any return and depreciation foregone between when the cost was incurred and the start of the next price control period. Without this assurance, companies will be discouraged from incurring efficient, but unanticipated, capex because they can, at best, get only a return below even the regulator's estimate of the company's cost of capital.

(f) Accept that such protection against the consequences of overspend implies, on grounds of symmetry, that companies will not benefit from capex underspend against price control assumptions.

11 Such an approach may be seen as (and, in fact, would be) a retreat from incentive regulation, as advocated by Ofgem. However, in our view, adopting the proposed form of incentive regulation (rolling incentives to reduce capex), in the absence of a solution to the capex uncertainty issue, would actually have the **perverse** incentive of discouraging efficient and necessary spend on energy networks at a time when the requirement to spend capital on those networks is rising. Against this background, a less incentivised form of regulation would, in this instance, be in the interests of customers.

Pensions

12 Ofgem's July document (Initial Conclusions on Developing Network Price Controls) set out a number of factors which would be taken into account in deciding how far companies would be allowed to recover the costs of pensions from customers. These factors included the extent to which:

(a) companies had paid different amounts into pension schemes from what had been assumed in setting successive price controls (the 'underfunding' issue);

(b) pension schemes have retained members who do not relate to the relevant regulated business (the 'regulated-unregulated split' issue); and

(c) companies have used past pension fund surpluses to part-fund severance programmes.

13 In our response to the July document, we suggested that the proposed use of these factors to reduce the amounts which companies could recover from customers was unreasonable because, inter alia:

(a) Past price reviews have already taken account of **aggregate** divergences between outturns and price control assumptions for each prior price control period.

(b) In the case of pensions, there is little or no audit trail for what assumptions have been made in past price reviews, with the exception of the most recent reviews.

(c) Ofgem seemed to be in danger of using hindsight to judge as inappropriate/penalisable decisions which, not least in relation to demergers, were eminently reasonable at the time the decisions were taken.

(d) As regards the use of pension fund surpluses to part-fund severance programmes, Ofgem (and its predecessors) have been well aware of the practice through past price reviews and have not taken any action other than to pass through to customers the benefits of the resulting reductions in ongoing operating costs.

14 Ofgem's latest statement on pensions is quite brief and clearly signals that the next main substantive stage in this debate will be on the back of the Methodology Statement which Ofgem proposes to publish in December and which will indicate how Ofgem plans to implement its principles. On the 'big three' pension issues (underfunding, regulated-unregulated split and use of surpluses to part-fund severance programmes), Ofgem's stated position is as follows:

(a) **Underfunding.** "Ofgem acknowledges the points that have been made and they will be addressed in bringing forward a detailed methodology statement in December 2003."

(b) **Regulated-unregulated** split. "Ofgem recognises the practical difficulties of reconstructing an appropriate basis of allocation and it intends to bring forward detailed proposals as part of the methodology statement in December."

(c) **Use of pension fund surplus to part-fund severance programmes.** Ofgem reasserts the principle that companies should make good any deficits resulting from this cause but "acknowledges that the position [that companies would have to make good deficits arising from this cause] might not have appeared at previous price reviews to be as clear as it is here described. Ofgem will therefore need to be satisfied that, in applying it in respect of redundancies occurring prior to March 2003, a proportionate approach is taken".

15 In other words, Ofgem would seem to acknowledge **some** limits on how far retrospection and hindsight can be taken on the pension issue but, beyond this, is looking to take the debate forward in December. We look forward to the next stage of this debate.

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