Electricity Distribution Price Control Review Second Consultation (December 2003)

Response by National Grid Transco on non-pensions issues

We respond in our capacity as the licensee for both gas and electricity networks in England and Wales and therefore share the DNOs interest in common issues for energy networks as well as some of the specific issues affecting NGC. We set out our responses here in the order that they appear in the consultation document.

Form of control – NGC Exit charges

Paragraph 3.18 questions whether DNOs are able to influence the level of NGC exit charges that affect them and if so whether they should continue to be treated as full pass-through. For the following reasons we are of the opinion that they should remain full pass-through:

- We have provided indicative data to Ofgem showing that on average the 'Plugs only' charging methodology to be implemented with effect from April 2004 will reduce NGC exit charges to DNOs by nearly 60%. This substantially reduces the materiality of NGC exit charges upon DNOs.

- This reduction has been achieved by the general shift of transmission voltage assets from connection to infrastructure. As a result and in future, the costs of these assets will be recovered from generators and suppliers through use of system charges, rather than through connectee's exit charges. We would also point out that, in re-classifying these assets, they have moved from NGC's excluded services to the main price control and, therefore, the incentive upon NGC to manage these assets efficiently has been increased.

- The majority of exit charges relate to **existing** assets and therefore the associated charges derive from the NGC price control set by Ofgem. The DNO allocation of these charges is determined by the NGC charging methodology, any changes to which have to be consulted upon across all users of the transmission system, not just the DNOs, and must be approved by Ofgem. We therefore consider that Ofgem has considerably greater influence over charges for existing assets than the DNOs.

- Exit charges may change due to replacement of existing assets or the installation of new assets. DNOs may have some influence where this occurs but we believe that the instances are isolated and the effect is marginal against the overall level of their charges.

- In the case of asset replacement, we believe that to incentivise the DNOs would reduce NGC's flexibility to manage its portfolio of asset replacement. As the document states in paragraph 3.17, NGC has a licence obligation to develop and maintain an efficient, co-ordinated and economical transmission system. We believe that Ofgem is better able to enforce this than the DNOs who both individually and collectively have incomplete information on NGC's asset replacement plans and the state and operation of the wider transmission system. To incentivise the DNOs could lead to protracted negotiation, delaying asset replacement, with potential implications for security of supply.

- In the case of new assets, generally only the Supergrid transformers are included in exit charges. Supergrid transformers require both transmission and distribution voltage switchgear to function. The transmission voltage assets are wholly within the NGC price control and the distribution voltage assets are generally within the DNO price control. Therefore both NGC and DNOs are already incentivised to some degree to manage the level of expenditure upon new connections. We therefore do not believe that further incentivisation is necessary or indeed beneficial.

Form of control – Business rates

Paragraph 3.53 questions whether DNOs have influence over the level of business rates levied upon them and whether they should have full pass through. NGC does have full pass through and we consider that this should be the case for all regulated utilities for the following reasons:

- We understand that business rates are to be based upon the value of the assets installed, or the profit arising from those assets, which is indirectly related to the asset value through the regulatory cost of capital. Similar to the arguments above for NGC exit charges, the majority of assets are existing and therefore the DNO has no influence over the resulting valuation. If DNOs were incentivised against the rateable valuation of new assets, then this would further disincentivise network capital expenditure - which would, in turn, need to be taken account of in the development of output based incentives.

- Nevertheless, we consider that where networks believe that there is reasonable scope for reduction of their rateable valuation, then they should appeal, as part of carrying out their duty to develop and maintain economic and efficient networks. However, appeals are likely to concern very large sums of money. If price control allowances were based upon an assumption of successful appeals then companies could be exposed to large losses if their appeals were unsuccessful. Conversely if allowances were based upon existing rateable valuations then companies could derive large windfall gains from successful appeals. This would suggest that full pass through should be applied.

- Finally, we believe that the Treasury intends to recover a predetermined level of revenue from business rates. If an electricity company successfully appealed against its rateable valuation then its reduction in business rates would be recovered across the remainder of the electricity companies as well as other sectors. Therefore, whilst incentivising companies against business rates may be of benefit to a group of electricity consumers it will be offset by the detriment to the remainder of the electricity sector and other sectors. Equally gains in other sectors would be to the detriment of the electricity sector. Therefore we believe that incentivisation would expose companies to unnecessary windfall gains and losses and all regulated utilities should have full pass through of business rates.

Form of Control – Dealing with uncertainty

In paragraph 3.60 Ofgem states that it may be appropriate for Ofgem to provide comfort that additional terms will be added to the price control to address issues such as lane rentals if the costs turn out to be material. We welcome Ofgem’s recognition of the severity and uncertainty presented by lane rentals and the Traffic Management Bill. If enacted as currently drafted, this legislation could place significant burdens upon companies, not just in terms of the cost of occupying the highway to carry out

their obligations but in terms of the cost of co-ordinating work and restoring the highway afterwards. At the time of writing there is considerable uncertainty over how this legislation will impact upon companies' costs. However, we believe that by the time Ofgem makes its final proposals there should be sufficient clarity for Ofgem to address this issue.

We are disappointed that Ofgem finds the water sector's interim determination and shipwreck mechanisms for dealing with cost uncertainty inappropriate to the energy sector. If incorporated into the licence such mechanisms would give greater regulatory certainty and remove confusion over the status of letters of comfort. We discuss Ofgem points below:

- **Ofgem argues that it has different principal objectives to Ofwat.** Whilst this is technically true, it is to some extent disingenuous because Ofgem's effective obligation to ensure that regulated entities are able to finance their obligations is similar to Ofwat's.

- **Ofgem claims that cost uncertainties are different in water to energy.** Historically water has experienced higher levels of investment than energy but, as a proportion of capital value, the energy sector is likely to catch up as asset age and distributed generation issues are addressed.

- **Ofgem claims that an interim determination introduces a significant burden on both regulator and company.** This is true and, for this reason, companies will not apply for such determinations lightly but only where cost shocks are significant and all other avenues have been exhausted.

Form of Control – Incentive Framework

Opex

We welcome Ofgem's proposals in paragraph 3.70 for a rolling opex adjustment. We note that Ofgem intends to allow companies to retain the benefits of out-performance, calculated from year by year incremental out-performance, for a five-year period.

We support the proposal that opex incentive allowances will not be negative in any given year as such negative allowances would add further penalty to companies for having costs in excess of those allowed for in the price control. The precise mechanism needs to be clarified. We support the methodology proposed in the ENA's letter of 26th January 2004 and look forward to publication of a definitive mechanism in the financial model.

Paragraph 3.71 invites views upon the exclusion of exceptional/atypical items. We believe that the comparison of outturn costs against allowances should be on a like for like basis. Therefore actual exceptional/atypical items should be excluded to the extent that they were not included or foreseen in price review allowances.

Additionally, where there is a material ongoing change in the operating environment (lane rentals for example), then this should also be taken into account. In addition, it would be helpful to clarify whether costs are measured on a cash or accounting basis and whether pension costs should be excluded if they are to be treated as pass through.

Capex

The consultation paper proposes a regime where:

- Companies with capex outturns less than allowances will be rewarded through the rolling capex adjustment mechanism.
- Companies with efficient capex outturns greater than allowances may not be penalised through the rolling capex adjustment mechanism but rather would be remunerated such that they are no better or worse off compared with expenditure being incorporated in the RAV straight away.

We agree with both of these principles individually. However, we do not believe that Ofgem has adequately considered the combination of these two principles. For example if we consider a hypothetical company with an allowance of £100 to deliver 100 units of output. In the event it delivers 120 units of output for £110. On the face of it the company has over-spent its allowance by £10. This additional £10 cost should be retrospectively incorporated into the RAV as it is clearly linked to increased output. In addition the company should be rewarded for £10 of efficiency savings although this does not appear to be reflected in Ofgem's proposals.

In the above example, the outputs are clearly defined and it would be possible to construct an appropriate revenue driver to adequately reward the company for both out-performance in the delivery of outputs and for the delivery of additional outputs. Ofgem's concern stems from the inability to identify appropriate outputs. If appropriate outputs, or a proxy therefore, cannot be found ex-ante then it will not be possible to construct an effective revenue driver. In such cases, Ofgem must choose between pass through of additional costs or ex-post adjustments to allowances. Failure to adopt either of these will be a disincentive to companies to undertake investment not covered by capex allowances.

Quality of Service and other outputs – Guaranteed and Overall Standards of Performance Exemptions

Paragraph 4.7 proposes that the exemptions from the standards of performance could be tightened or removed from industrial action by a company's employees as this is to a large degree within a company's control. This could significantly alter the balance of power in trade union negotiations, with significant potential detriment for consumers.

Financial Issues – The Financial Ring-fence

Paragraph 7.14 proposes a cash lock-up mechanism such that a network whose credit rating falls to or below minimum investment grade would be unable to make distributions without Ofgem's prior consent. As with any future special administrator regime, it would be important that the criteria for triggering such a cash lock up would be sufficiently clear and aimed at minimising regulatory discretion. In addition, any lock up which operated before a network's credit rating had fallen below BBB- (or had fallen to BBB- with a negative outlook) would, in effect, imply a raising of the minimum credit rating required by the licensee.

Financial Issues – Financial Indicators

In paragraph 7.55, Ofgem states that it will undertake supporting checks on the prospective financial position of each DNO under the proposed price controls to ensure that it is able to maintain access to the requisite finance on reasonable terms.

We support this process but find it hard to understand how the adjustments to capital structure and taxation in Ofgem's modelling proposed in paragraph 7.57 are consistent with this. Checks on financial positions can only be based upon actual capital structures to reflect the actual costs incurred by networks.

National Grid Transco
10 February 2004