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ENERGY
NETWORKS
ASSOCIATION

6 May 2004

Dear David,

Re: Electricity Distribution Price Control Review – Policy Document (March 2004)

The Energy Networks Association (ENA) is the industry body that represents gas and electricity transmission and distribution companies in the UK. We are pleased to provide comments on your Distribution Price Control Review Policy Document.

Our comments are confined to three key areas of the document where Member companies have particular and common concerns and where we believe Ofgem's proposals are not in the long term interests of customers. These relate to:

- Ofgem's new thinking on the appropriate incentive framework to apply during the forthcoming review period, particularly in relation to the classification of costs between capex and opex and the weakening of capex efficiency incentives. Rather than weaken these incentives we believe that what is required is a strengthening of the companies' incentives to deliver their investment plans, if efficiency is not to suffer and costs increase.
- The proposed treatment of pension costs, in particular Ofgem's proposal not to include Early Retirement Deficiency Costs (ERDCs) in companies' future allowed costs even though customers have already benefited from their usage and companies were given no indication that they would be treated in such a way; and
- The allowed cost of capital to be used to set future revenues where Ofgem's present proposals do not adequately reflect the risks of operating a distribution network business and are insufficient to attract and reward the investment necessary to replace an ageing asset base and support new distributed generation connections.

On each issue we have tried to comment constructively and to suggest alternative approaches to help reach mutually satisfactory conclusions. We have, of course, already commented to you on another issue, i.e. your proposed method for dealing with uncertainty during the next price control period, and submitted an alternative framework for your consideration.

The Proposed Incentive Framework

We recognise Ofgem's concerns about the incentives under the present regulatory framework for companies to re-categorise costs from opex to capex and for investment to be deferred for reasons other than purely operating efficiency.

However, we believe that Ofgem's proposed solution to this, i.e. allocating more costs to capex and weakening the capex incentive itself is inappropriate. This is because it will significantly limit the scope for companies to (legitimately) seek operating efficiencies to outperform their cost allowances. This will be to the long term detriment of customers as costs and hence prices will be higher than necessary. In addition, companies will also have less incentive to invest efficiently and to find cheaper ways of delivering the outcomes required of them. And this at a time when investment levels are increasing and the premium on spending the money wisely on behalf of customers is correspondingly higher. This seems to be fundamentally at odds with Ofgem's objectives for the price control, i.e. to maintain an appropriate balance between incentives to deliver and incentives for efficiency, to rely on RPI-X as the foundation of the control and to avoid distortion in the creation of a more complex structure of incentives.

In order to avoid this dilution of incentives, companies have suggested a number of alternatives which they will no doubt articulate in more detail in their individual responses. Implementation of one or more of these should give Ofgem comfort that companies will continue to seek ways of delivering outputs more efficiently and will not simply re-allocate costs to capex or defer necessary capital expenditure. Some examples include:

- Defining cost allocation rules more clearly going forward
- Due diligence by consultants
- More extensive output reporting and/or monitoring with transparent eligibility criteria to qualify for the payment of rewards.
- Development of a scheme to measure and incentivise network resilience.
- Sliding scale approach to capex underspends (as described by SSE at the recent Ofgem Workshop) which will limit the benefits from any shortfall in excess of 10% and penalise major shortfalls above 30%.

We would urge Ofgem to review these alternative suggestions before taking the present proposals any further. The Ofgem/DNO Incentives Working Group is due to meet on 11 May and we propose that this issue is progressed as a matter of urgency at that meeting in time to inform the forthcoming proposals document in June.

Pensions – The Treatment of Early Retirement Deficiency Costs (ERDCs)

Companies remain concerned by Ofgem's proposal not to include ERDCs in their allowable costs for the next review period. Our belief is that the provision of pension benefits under severance arrangements has resulted in direct savings to customers and as such costs associated with the provision of these benefits must be treated as a legitimate business cost.

The appropriate regulatory treatment of ERDCs depends upon the adoption of a consistent view of past decisions under a price cap regime designed to incentivise efficiency. The key principles are**:**

- If past decisions were efficient, distributors should not suffer for them, i.e. they should expect to recover all costs associated with them.
- Any ex-post review of the distributors' decisions, to see if they were efficient, should judge each one by the information available at the time, not by information which only became available later.

In the current regulatory period, distributors took decisions (that Ofgem itself defines as rational) to encourage early retirement of their employees because, at the time, all reasonable opinion suggested that the funds would remain in surplus for the foreseeable future. The decisions were taken to enable companies to meet Ofgem's DPCR3 cost targets reflecting the only way in which companies are able substantially to affect costs – by cutting staff. Where these decisions were taken before March 2001 they were then supported by the results of the subsequent actuarial valuations that concluded that the schemes would remain in surplus even after taking into account the use of the surplus. These decisions benefited the companies in the first instance (because it immediately reduced salary costs during the current regulatory period) and provided a greater benefit to customers in the long run (when the resulting lower salary costs fed through into lower prices in perpetuity).

These represent prudent business decisions, for which, on the basis of the first regulatory principle above, the distributors should not now be penalised. Since then, conditions have changed and as a result of the deficit at 31 March 2004, the distributors will have to increase their contributions. However, the companies could not have known this at the time. So, on the basis of the second principle above, subsequent information that higher contributions are required provides no justification for re-assessing the decision of distributors to incur ERDCs.

Ofgem acknowledges that the early retirement costs have not been recovered, and also that customers have benefited from the incurring of those costs. But it now proposes to exclude them from allowed costs going forward, on the basis that there was no *agreement* that such costs would be recoverable from consumers. This position is difficult to understand on two counts.

First, since Ofgem did not announce at the time that such costs would (or might) not be recoverable, companies will have taken decisions about ERDCs and the use of surplus on the basis of a rational expectation about Ofgem's future actions, consistent with the principles of good regulatory practice. During the protracted discussions with NGC over the use of pension fund surpluses since before the last review, the practice within the industry of using them to fund early retirement programmes was well documented and well understood by Ofgem. It would be expected that had Ofgem had concerns over this it would have informed the companies.

Furthermore, as it made little or no allowance for severance costs at DPCR3, Ofgem would have known that the companies' cost targets could only be achieved by redundancies and the associated pension costs, costs which would have been inflated as a result of companies' statutory obligations associated with their 'protected' employees who were employed within the industry prior to privatisation.

Secondly, to demand that distributors produce evidence of an *agreement* to allow recovery of these costs puts them under an impossible burden of proof. In the December 2003 Consultation Paper, companies were asked for any evidence of any commitment or basis for expectation that ERDCs would subsequently be recoverable from customers. However, in March, Ofgem states that whilst several companies provided such evidence (para. 7.31), no companies (para. 7.43) have produced any evidence of any agreement that consumers should bear these costs – the reference to 'basis for expectation' has gone. As Ofgem is well aware, there is no evidence of agreement to pass through *any* category of cost under a future price control. It has not said why a requirement for such evidence should apply to these costs alone, or how the distributors should fulfil such a requirement. Ofgem did not tell distributors to collect proof of agreement in relation to ERDCs at the time, nor does it now say how they could have collected such proof.

We believe that distributors are entitled to recover all the costs associated with their ERDC decisions, including the increase in pension contributions that is now required. Any treatment of these costs that does not properly reflect this entitlement would effectively penalise efficient decisions, and importantly, discourage similar decisions in future so representing a further reduction in the incentives for cost reduction.

It is therefore the companies' contention that Ofgem should:

- Make allowance for any additional cost of replenishing pension funds to the extent that previously assumed surpluses were used to fund cost-saving programmes from which customers benefited through lower prices and

- Explain any disallowances by reference to the specific past actions by companies that were demonstrably inefficient or imprudent and therefore should not be borne by customers.

Cost of Capital

We welcome the transparency of Ofgem's discussion of the WACC to be used for the next price control period and its acknowledgement of the importance of providing a sufficient and stable return for companies to attract the necessary funding from capital markets. There is no doubt that future investors' confidence would be undermined by a cost of capital that is too low and this would have serious implications for the long term sustainability of the network infrastructure and the achievement of Government targets for renewable generation.

In the companies' view this points to a cost of capital for the review at least at the top of Ofgem's current range for the vanilla WACC of 5.1% – 5.9% and should also include allowances for (efficiently incurred) embedded debt and debt issuance costs.

Also, the allowance for tax needs to be consistent with the level of gearing assumed in the balance sheet of each DNO as part of any financeability test used to ensure that the price control can be appropriately funded.

Furthermore, Ofgem's range for the post tax WACC, i.e. 4.2% - 5% is low in comparison with that used by Ofwat during the water review (5%) which is inconsistent with the respective risk profiles of the industries.

Member companies have furnished you with two studies from respected consultancies (OXERA and NERA) both of which point to a cost of capital at least at the top of Ofgem's current range. This research highlights the cost of equity derived from the dividend growth model (DGM) and the regulatory precedent (for example, BAA) of using a cost of capital figure higher than the midpoint of the range when a significant investment programme is planned. This has been supplemented by authoritative evidence from UU's experience from their recent rights issue, the opinion of senior city financial analysts at Ofgem's own workshop, and evidence from abroad.

Indeed, there is considerable regulatory precedence for using the DGM as a check on the results of the Capital Asset Pricing Model (CAPM). Recent academic research shows that estimates of the cost of equity using DGM are at the higher end of the range identified by CAPM for the distribution companies. In addition, market evidence over the current regulatory period implies a dividend yield of 4.9% to 6.8% with a mid-point of 5.9%. With growth of 1 to 2%, this supports a post tax cost of equity of around 7.5%, consistent with a fully post tax WACC of 5.0% (5.9% vanilla).

We also believe that Ofgem's initial range of between 1% and 1.8% for the debt premium is too low as it does not take account of the cost of (efficiently incurred) historic debt or debt issuance costs. We believe that the figure at the top end of the range should be increased by 0.5% to account for these factors.

We would therefore urge Ofgem to re-consider their current proposals for the WACC to be applied during the next review with a view to settling on a figure at least at the top of the quoted ranges.

I trust you will find our comments helpful. It is very important that we obtain agreement with you on these issues ahead of its proposals document in June and look forward to discussing them with you in the very near future.

Yours sincerely

Nick Goodall
Chief Executive

cc: Nienke Hendriks