

NGT Response to Electricity Distribution Price Control Review Policy Document (March 2004)

Section 3 – Form, structure and scope of the price controls

Price Index

Ofgem invites views on the use of the Harmonised Index of Consumer Prices rather than the Retail Price Index. In our view, RPI should be retained both in the main price control formula and as the basis for indexing regulatory asset values. This is not least because:

- The use of RPI for indexing regulatory asset values is based implicitly (or explicitly in the case of some other UK regulatory bodies) on the Financial Capital Maintenance approach to asset valuation, i.e. on the value of assets to investors. RPI is the most broadly based index of prices for investors (in their role as consumers). By and large, most investors/consumers are not indifferent to housing costs which are largely excluded from CPI. Therefore, the broadest possible measure of consumer prices (i.e. RPI) is the most appropriate basis for indexation of regulatory asset values.
- It would be somewhat odd to index the overall price control formula on a different basis from the indexation of regulatory asset values. However, if CPI was chosen for the overall price control, there would need to be allowance for the various ways in which the CPI/RPI difference impacts on the revenue calculation. This includes: the impact of RPI inflation on wage costs and, thus, on costs more generally; and the role of RPI in determining the risk free rate input into the WACC calculation.
- More generally, it would also be odd to prefer CPI to RPI when, for the last not so few years, RPI has (rightly in our view) continued to be used for regulatory purposes, in preference to RPIX, the previous target for monetary policy.

Transmission Exit Charges

We welcome Ofgem's decision to allow DNOs pass through of NGC exit charges. We would like to draw Ofgem's attention to certain issues that NGC is considering that could result in DNOs being included in the charging base for other NGC charges. Whilst these issues are still in their infancy it may be appropriate to design cost pass through and uncertainty mechanisms with them in mind.

- NGC has noted recent applications for so called Grid Supply Points (GSP) whose only end-customers are licence exempt generators. These GSPs will, therefore, normally export to the transmission system. In addition, NGC has noted that some existing GSPs are increasingly exporting at certain times due to embedded generation. NGC believes that such GSPs impose a cost upon the transmission system and intends to review whether the embedded benefits that are currently enjoyed by licence exempt generation in these groups should be revised. This might be done either by charging generators directly or by levying Generation Transmission Use of System charges upon the host DNO. We believe that DNOs should have full pass through of any such charge.
- If NGC proceeds with levying Generation Use of System Charges on DNOs with exporting GSPs, the current practice of levying Demand Use of System charges upon suppliers will need to be reviewed. For example, if a GSP has gross generation greater than gross demand such that there would be a net export to the transmission system, it would seem inappropriate to base a DNO's

generation charge upon the net export and a supplier's demand charge upon the gross import. It may be more appropriate for DNOs to pay both demand and generation use of system charges with some degree of netting off. Again, we believe that DNOs should have full pass through of any such charge.

- NGC is installing greater and greater amounts of reactive compensation upon its system in order to maintain compliance with voltage standards. We believe that one of the drivers for this is degradation of power factors at the NGC/DNO interface. NGC believes that it would be more efficient for compensation to be co-located with the demand or, failing this, for compensation to take place at distribution voltages. However, there are currently no incentives upon either DNOs or Suppliers to do this. NGC could devise a charging structure to pass on the cost of reactive management to DNOs. The DNOs could, in turn, reflect this in the structure of charges to their customers or install their own compensation. If NGC were to introduce a reactive power based charge, DNO allowances would need to be reviewed as they do not currently have to pay such a tariff. Alternatively, they may require additional capital expenditure upon their system to manage power factors efficiently. However, we do not believe that the DNOs should have pass through of this element because this would remove the desired incentive.

Price Control for Metering Services

We agree with Ofgem's approach to the separation of the distribution and metering price controls.

Stranding

Both regulated and non-regulated asset owners require assurance that the asset will remain installed for its expected life. We believe that early meter replacement is not in the interest of consumers and therefore the price control should be structured to mitigate this risk. Going forwards, commercial contracts will evolve to protect asset lives. However, for the existing installed DNO assets, there are two approaches:

1. Assets are assumed to provide an income for the remainder of their designed life. Where assets are removed earlier then termination amounts reflective of the remaining life would be charged.
2. On average assets are assumed to be removed before the end of their remaining life. Tariffs are increased to reflect this by adjusting the cost of capital and/or depreciation assumptions.

The parameters for both options can be set such that they deliver the same expected value. However, option 2 carries a risk of more asset replacement than assumed, particularly as it results in higher initial charges. This risk cannot be addressed by increasing tariffs at a later date, as this would only exacerbate the incentive to replace assets early.

Therefore, for existing assets, we believe that Ofgem should set a revenue cap reflective of operating costs and the stranding risk. Within this cap DNOs should be allowed flexibility to structure their charges around either of the above options according to their desire to remain in, or exit from, the metering business.

Form of Price Control

We recognise the need to protect customers for MAP charges on meters fitted prior to 1 April 2005. These should be subject to a price cap until the last of these assets is removed in the 2020's.

However, we would support the removal of price controls for MOP activities and MAP charges on new meter installations from 1 April 2005. Suppliers are currently able to seek both of these competitively. Ofgem is currently conducting a survey of competition in metering. If Ofgem decides that the market is insufficiently established then the duration of price controls for these activities should be short and definite in length. This would encourage suppliers to pro-actively seek competitive arrangements thus stimulating the market, rather than relying upon emergent competition.

Ofgem should aim to remove the DNO licence obligation to provide metering services by April 2007.

Original Installation charge

The original installation costs for existing meters appear to have been "lost" in the current published metering charging statements. The installation charges should have been capitalised and included in the DNO's RAV. In splitting the RAV into Distribution and Metering, the original installation cost should be included in the metering RAV.

Definition of Metering System

The definition of a metering system is currently not explicit. We support the definition in the Forecast Business Plan Questionnaire Guidance Notes, although the current DNO metering charging statements exclude meter tails, connector blocks, contactors and isolation switches. Confirmation from Ofgem of the scope of MAP with respect to the legal ownership of equipment would be beneficial.

Average Revenue Caps – Revenue Drivers

It is difficult for metering companies to clearly differentiate between domestic and I&C customers. A better split may be, credit & prepayment meters and CT operated meters. Any cross funding between meter types (e.g. credit/pre-payment) should be removed as this could significantly distort the competitive market.

Basic Metering Services

Paragraphs 3.97 to 3.101 clearly indicate the difficulties associated with trying to define 'basic' metering services. If the MAP price control is limited to the existing asset base as at 31 March 2005, then the difficulties of defining 'basic' metering, and any associated 'gaming' thereafter, do not need to be considered.

Section 4 – Quality of Service and Other Outputs

In paragraph 4.38, Ofgem sets out two options for auditing interruption data. We believe that the proposal for companies to audit their data and then for Ofgem to conduct random audits would have a higher regulatory burden, and therefore cost, than Ofgem carrying out a streamlined audit for each DNO. Targets for accuracy

should be realistic and achievable for each company. Furthermore, penalties should be proportionate to the harm caused to consumers.

Section 5 – Distributed Generation, Innovation Funding and Registered Power Zones

Distributed Generation

We note all O&M costs associated with DG related investment are to be recovered through the incentive rate whereas 80% of capital costs are to be passed through. This implies that stranded assets should be abandoned such that they do not incur O&M costs. Abandonment would be irresponsible, both from a safety and environmental perspective, and therefore we do not believe that this is a reasonable treatment. As for capital costs a proportion of O&M costs should be treated as pass through.

Paragraph 5.31 states that the incentive rate would be reviewed if the return earned by a DNO across its portfolio of distributed generation varied outside of the floor or cap on returns. It is unclear if the whole incentive rate would be adjusted including the O&M component or just the financing component. We believe that the O&M component should be included.

Paragraph 5.27 describes the locking in of the incentive rate such that the incentive rate over the life of an asset is fixed, as is the incentive rate to which a generator is exposed. We are concerned that should Ofgem revise the incentive rate at a future review then very different rates might apply to correct the returns on existing projects. This will lead to generators being exposed to different charging rates depending upon when they connect. This would appear to be discriminatory because it will lead to similar generators on the same DNO network paying charges on different costs bases. It would be preferable to charge both new and existing generators on the same cost-reflective basis. Where it is not politically acceptable to adjust an existing user's charges then residual costs could be socialised across all customers.

Paragraph 5.38 invites views on whether micro-generation should be included in the incentive arrangements. We believe that it will be difficult to define 'micro' and if such a definition was found generation projects might attempt to 'game' the definition. Therefore we consider that all generation should be included where it is practicable to monitor its connection.

Paragraph 5.39 describes compensation arrangements for network unavailability. We agree that the incentive rate should be fixed, or related to use of system payments, rather than to customer's losses. The rate proposed could potentially result in a DNO paying out more in compensation than it receives in income from a generator. Given the need to develop novel solutions to accommodate embedded generation we believe that initially the risk should be capped, either by limiting compensation payments or by sharing the cost across the DNO's other customers.

Registered Power Zones

The table in paragraph 5.57 states that the RPZ incentive will be reviewed in 2007, mid price review period. DNOs will invest in RPZ projects against a reasonable expectation of recovering their costs under the RPZ incentive rate. Consistent with the incentive rate lock-in described in paragraph 5.27, the 2007 review should not alter the financing of existing projects.

Section 6 – Assessing Costs

Paragraph 6.15 suggests that for the purposes of setting DNO's revenue allowances an underlying level of atypical and one-off costs or credits **may** need to be included in revenue allowances. We note that the rolling opex incentive will include atypical costs. Therefore, for the comparison of allowed to actual costs under the incentive mechanism to be consistent, an allowance for atypical and one-off costs needs to be incorporated into assumed DNO costs.

Section 7 - Financial Issues

Cost of Capital

Companies have met shareholders expectations to date through allowed returns on the RAV and through out-performance of regulatory expectations. Ofgem's proposals to capitalise certain categories of operating costs and to reduce the incentive to defer capital expenditure will reduce the reward for out-performance and therefore the ability of companies to deliver returns to shareholders. The policy document and its appendices necessarily refer to past market data. However, in setting the WACC going forwards, Ofgem should have regard to the discontinuity in incentives that it is introducing and the need for companies to have a reasonable chance of meeting investor expectations.

We note that Ofgem is proposing a post-tax range of 4.2 to 5.0%. Ofwat published its view in MD190 that it sees no strong evidence for a post-tax cost of capital of less than 5.0% (excluding small company premiums) for water and sewerage companies. Like the water sector, electricity distribution is asset intensive and is about to embark on a significant increase in capital expenditure. Ofgem is reviewing electricity distribution on the same timescale as Ofwat is reviewing water and has shared the same advisors and consultants on financing issues. We would therefore expect Ofgem and Ofwat to determine similar WACC or to explain their differences.

We believe that Ofwat has reached its opinion in recognition that the cost of capital allowed at the last water review was too low, such that water and sewerage companies have since traded at discounts to their regulatory value. There is a danger that by simply basing the cost of capital for electricity networks upon recent market observations, which reflect (inter alia) the past scope for out-performance against the assumed cost of capital, Ofgem could make a similar mistake.

Treatment of Pension Costs

Allocation Between Price Controlled and Other Activities

Ofgem's Position

Ofgem's position is 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, then, for the purpose of calculating regulatory allowances, a proportion of the pensioners and deferred pensioners will be deemed to have left the pension scheme ("disallowed pensioners"). Consequently, a proportion of any deficit attributed to the disallowed pensioners, and the cost of funding that part of the deficit will not be considered as attributable to the regulatory entity for price control purposes, causing the price control allowance to be less than the actual costs faced by the regulated entity.

The implication of Ofgem's position would seem to be that, in the case of a surplus in the pension scheme, a proportion of the surplus will be attributed to the disallowed pensioners, and the reduction in cost arising from that part of the surplus will not be considered as attributable to the regulatory entity for price control purposes, causing the price control allowance to be more than the actual costs faced by the entity.

NGT's Comments

NGT's comments on this issue were set out in full on 10 February 2004, in response to the previous Consultation Paper.

In summary, we do not believe that, as applied to the Centrica de-merger, Ofgem's proposition is reasonable in principle on the grounds that:

- It was **not possible**, at the time of de-merger, to split pensioners and deferreds between the two relevant entities.
- It would **not have been reasonable, at the time of de-merger**, to expect the two companies to have put in place risk sharing arrangements in respect of future deficits or surpluses.
- At **neither** of the two price controls, subsequent to demerger, did Ofgas, the MMC or Ofgem envisage any regulatory partitioning of the pension scheme.

If Ofgem is determined to follow this path, however unreasonable, account must be taken of the **benefit** which Transco's customers have had from the "Centrica" share of the surplus.

Over or Under Provision

Ofgem's Position

Ofgem's proposal is that future over or underpayments made by companies against price control assumptions should be carried forward to the next price control period. Ofgem does not consider it necessary to make these adjustments on an annual basis. This will apply with effect from 1.4.02 for Transco, and not before 31.3.06 for NGC.

NGT's Comments

NGT welcomes the proposal to apply over and under-provision adjustments to Transco with effect from 1.4.02.

In respect of whether adjustments are made on an annual basis or at price control reviews, the key issue under either regime is **clarity**. It is highly desirable that companies are able to calculate the amount of the regulatory pensions asset or liability, which they are creating. When the regulatory rules are not clear, this serves to increase the risk associated with the sector and hence the returns demanded by investors, as stated by the City Analysts at Ofgem's recent Public Workshop.

Early Retirement Deficiency Contributions ("ERDCs")

Ofgem's Position

Ofgem's 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, then this £10m, plus lost return would be added to pension fund assets in Ofgem's notional actuarial calculation in order to reduce the opex allowance for pension costs.

NGT's Comments

NGT's comments on this issue were set out in detail on 10 February 2004, in response to the previous Consultation Paper, and are summarised below.

We do not believe it reasonable to retrospectively claw back amounts of surplus used to part fund severance programs on the grounds that:

- It would involve taking a different, with the benefit of hindsight, view of information, which has been available to regulators for around a decade.
- Such second bites at a given company action imply that no past action by a regulated entity will ever be definitely judged acceptable – increasing investors' perception of risk and thus raising the cost of capital of regulated utilities.
- Customers have benefited substantially from severance programs in excess of those assumed when price controls were set – using Ofgem's numbers, at least 70% of the benefit has been, or will be, received by customers. As a result, 100% clawback would result in a near double benefit for customers, but a substantial hit for shareholders

Arising from this Consultation paper, we have some additional comments, on the following matters:

- the change in Ofgem's stance on evidence of companies' expectations
- Ofgem's new justification for claw-back of all use of surplus

In respect of the first point, NGT is very disappointed that Ofgem has apparently changed its stance, now choosing to **disregard** whether or not companies had a **basis for the expectation** that use of surplus by ERDCs would not subsequently be clawed back.

The December paper, paragraph 7.87 states that "...Ofgem is not aware of any commitment or **basis for expectation** that these costs (ERDCs) could subsequently be recovered from consumers as part of the next price control review. Ofgem would be prepared to **consider any evidence** that affected parties or other interested parties can provide on this issue."

In our response to the previous Consultation Paper, NGT (and others, as acknowledged by Ofgem in paragraph 7.31) provided a large amount of evidence demonstrating that it had a strong basis for that expectation. To recap, NGT has two key reasons for that expectation:

- **The first reason** is that Ofgem and Offer were aware from 1995 onwards that NGC was using surplus, but did not act, or even hint, not least when setting

subsequent price controls, that the practice was unacceptable or even undesirable in any way.

- **The second reason** is that Ofgem has not adjusted price controls to disallow the increase in pension costs caused by previous use of surplus. If one accepts the premise that this use of surplus is damaging to consumers (which we do not), then consumers have largely already paid for it, the cost to consumers starting within 3 years of the use of surplus – being higher contributions required from the next actuarial valuation.

Having submitted this evidence, we find that the **goalposts have moved**, as evidenced by paragraphs 7.43 and 7.44; “No companies have yet produced any evidence that there was any **agreement** that consumers would bear these costs if they subsequently materialised. Therefore Ofgem is still minded not to allow any ex post pass through of these costs to customers.”

It would appear that Ofgem has **implicitly accepted** that companies had a basis for this expectation, but has decided to **disregard** this when formulating its policy.

In respect of the second point, one of the reasons used to justify Ofgem’s stance on ERDCs is that of balance or proportionality. As described in paragraph 7.40, the price the DNOs will pay for Ofgem not penalising them for their past underpayments is the clawback of all unpaid ERDCs. Paragraph 7.39 states that “For the distribution businesses, Ofgem considers that the available evidence suggests that companies have probably contributed substantially less than was envisaged in setting the price controls over the period since 1995. This appears less likely to be the case in 2003/4 and 2004/5. The amounts involved may well exceed £100m across the industry – however, the lack of explicit allowances makes precise quantification difficult.”

NGT has comments in respect of the logic which flows from this, and also in respect of the calculation itself.

In respect of the logic, in Ofgem’s view a balanced approach is produced by clawing back ERDCs but taking no account of earlier **underpayments** against price control assumptions. Logically, if there are earlier **overpayments** against price control assumptions, as in the case of NGT, then a balanced approach would demand that ERDCs were not clawed back.

In respect of the calculation of the £100m:

- In the December 2003 paper the calculation of the allowance for the DNOs for the period 2000-2005 was considered so difficult by Ofgem that it set out 3 methods of performing the calculation, each of which would be expected to produce widely differing results. How can any reliance possibly be placed upon so arbitrary a calculation and which of the 3 methods has been used here?
- It is not clear whether the figure of £100m has taken account of the overpayments made by companies in 2003/4 and 2004/5 – it clearly should
- It is not clear whether severance related payments included in the figures – they clearly should
- The choice of 1995 as the start point for the analysis appears arbitrary – why was this year chosen and not an earlier or later one?

Given that the policy to clawback all the historic use of surplus in severance programs is at least partly justified by this calculation, it is essential that both it and the relevant assumptions underlying it are seen to be robust. Consequently it would appear essential that these are **placed in the public domain**, for scrutiny and comment.

To summarise, in respect of the additional information in the March Consultation paper in respect of ERDCs:

- In Ofgem's view the DNO proposition is balanced because DNOs underpaid in previous price control periods. This logic suggests that, because NGT has overpaid relative to price control assumptions, that no ERDCs should be clawed back from NGT.
- The calculation underlying the assertion that DNOs have underpaid relative to price controls is so important that it and the underlying assumptions should be placed in the public domain.
- We are very disappointed that, having asked for evidence that companies had a basis for expectation that ERDCs were recoverable in future periods, Ofgem has chosen to disregard this evidence.

Finally, several times in the Consultation Paper, the terms "proportionate" and "balance" appear. It seems to NGT that an approach which claws back 100% of past use of surplus in severance programs in the face of customer benefit from those programs, disallows whichever part of Transco's deficit which Ofgem deems to be attributable to Centrica pensioners, and gives no credit for overpayments prior to this price control period cannot reasonably be described as proportionate or balanced.

National Grid Transco
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