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Dear Cemil

Response to Electricity Distribution Price Control Review Initial Proposals

In this response we focus upon new issues raised by the Initial Proposals document, namely:

- Investment Incentives
- The losses Incentive
- Metering Price Control
- Cost of Capital
- Tax Treatment
- Financial Indicators
- Early Retirement Deficiency Contributions

Investment Incentives

Our main concern is with the investment incentive proposed in section 6.95 (which is designed to encourage capex forecasting accuracy) and how the mechanics of this incentive will interact with the rolling capex incentive and also how the treatment of capital overspends will be incorporated.

Taking the first of these points, the March Policy Document proposed that 'companies will be able to retain the benefit of all capex efficiency savings for a fixed period of five years[1].' With a 6.6% pre-tax cost of capital and a 20-year depreciation period, a fixed five-year retention of both return and depreciation equates to a marginal incentive rate of approximately 49%.

To reduce the incentive rate to 20% as presented in Table 6.9, we assume that either the depreciation element is being reduced (5 year retention of just return equates to an incentive rate of approximately 26%) and/or the retention period is being reduced (2 year retention of both return and depreciation equates to an incentive rate of approximately 22%.) It is not clear which approach is being used although we note that the latter approach is a deviation from a five-year retention period, albeit that the effect is similar.

Our second point concerns the interaction with capital overspends. Section 6.92 states that one of the aims of the sliding scale mechanism is to allow, but not encourage, spend

[1] Table 3.1, Electricity Distribution Price Control Review, Policy document, March 2004

in excess of the allowance. The policy set out in the March Policy Document was as follows:

- if there is clear evidence of wasteful and unnecessary spending then this will not be included in a licensee's RAV;

- if costs are higher than allowed at the last price control review, but are nevertheless consistent with efficient spending, in general there will be a symmetrical treatment of under and over spend. Therefore a company could expect to have to meet at least the return element of financing costs of any overspend for a full five year period – after the elapse of this period the amount of the overspend would be added to the RAV; and

- where costs are higher, consistent with efficient spending, and this can be clearly shown to provide significant benefits to consumers (e.g. in being essential for security of supply), Ofgem would consider allowing the company to recover the regulatory depreciation and return from the year the expenditure is incurred.

With respect to the first category of wasteful expenditure, Ofgem intend to completely disallow this expenditure, i.e. it will not be added to the RAV and the company will have to bear the full cost itself. However, to include this expenditure within the incentive mechanism, whether or not the company has exceeded its overall allowances, would subject the company to the double jeopardy of having to fund the investment itself and being penalized by the incentive mechanism. Therefore, this expenditure should be excluded from the incentive mechanism as it is already subjected to a 100% marginal (dis)incentive rate.

The second category of expenditure associated with higher costs would appear to be suitable for inclusion in the proposed incentive mechanism at whatever marginal incentive rate was derived at the price review. However, to the extent that a company had foreseen this expenditure and included it in its forecasts, but PBPower had not, the company's forecasting accuracy should not be penalised. In such cases, consideration might be given as to whether capex allowances derived from the PBPower forecast should be adjusted retrospectively.

The third category of expenditure associated with higher costs and with consumer benefits would presumably be separately identified as part of the review of historic capex. In keeping with the criteria in the March Policy Document, this expenditure should be excluded from the investment incentive, i.e. it should not be subjected to a fixed retention period for either return or depreciation.

Paragraph 6.93 of the initial proposals states that, in principle, companies can choose between a lower cost allowance and a higher-powered incentive or a higher allowance and lower-powered incentive. The proposals set out allowances for companies based upon the data submitted by companies in their business plans. It is therefore not obvious how companies will 'choose' between these options. We understand that companies will be submitting data for 2003/4 and that they will have an opportunity to revise their forecasts at the same time. This would seem to present an opportunity for this choice to be made although in doing so we would also expect Ofgem's capex consultants to revise their own forecasts in the light of this new information.

<u>The Losses Incentive</u>

We would like to see workings of the transmission cost element of the losses incentive. The effect of losses varies across the country, implying that the transmission cost of losses should also vary. The use of an average figure will tend to over-value losses in the north of the country and under-value those in the south which will lead to inefficient investment decisions.

Metering

Structure of control

We note the intention to establish price caps for the provision of domestic credit meters and prepayment meters and to introduce a licence condition requiring DNOs to use a non-discriminatory approach to calculate both price capped and non-price capped charges. Indicative ranges for the price caps for each DNO are set out in Table 3.3. The information in the table suggests that there is likely to be a wide variation in the level of price caps between DNOs. Given the proposal to value metering assets based on depreciated replacement cost, which will effectively mean that the historic differences between the DNOs of procuring and financing meters are allocated to the distribution business, we would have anticipated that the range of price caps would be more closely aligned.

Definition of meter assets

We believe that the definition of metering assets used in paragraph 3.50 requires further clarification. In our opinion it should include all metering equipment from the out-going terminal of the cut-out through to the equipment of the consumer i.e. up to and including the out-going terminals of the meter (or time switch). Without further clarification, we believe that there will be continued uncertainty regarding ownership of the various components of the metering system.

Basic Services and One Way Door

We support the approach whereby DNOs and suppliers will be allowed to contract freely between themselves for different qualities of service to the "basic service" and at different prices. We also support the "one way door" proposal, whereby the DNOs would not be obliged to provide metering services to suppliers in relation to meter points at which they have appointed alternative metering service providers. This will enable DNOs to forecast with greater confidence the demand for their metering services and match resources accordingly.

Long term switch off

We support the proposal to switch off the provisions of standard licence conditions 36 to 36C, in so far as they relate to meter operation and the provision of new metering assets, with effect from 1 April 2007. However, it is not clear from the wording in paragraph 3.71 whether the provisions will be switched off in respect of the provision of meter operation services for both new and existing meter assets or new assets only.

Cost of Capital

The document presents an illustrative post-tax WACC of 4.6%, which is in the middle of the range identified in the March 2004 Policy Document. The return to investors is a combination of Ofgem's ex-ante assumption of WACC and the variance of company performance from regulatory assumptions.

The adequacy of Ofgem's WACC assumption will ultimately be determined by investor willingness to fund capital requirements in the context of the perceived risk-reward profile and opportunities available elsewhere. Generally, analysts have expressed disappointment in Ofgem's proposed WACC and inevitably made comparisons to Ofwat's proposals. We recognise that Ofgem is not responsible for Ofwat's opinion but are nonetheless concerned that Ofgem's proposals do not appear less attractive than those recently proposed by Ofwat. In particular, we note that the water sector has more clearly defined mechanisms for dealing with cost uncertainties and that both sectors have large capex programmes necessitating further investment.

The variance of company performance from regulatory expectations may increase or decrease returns depending upon:

- **The variation of outturn costs relative to regulatory assumptions.** Lower cost assumptions inevitably reduce the scope for out-performance. The opex assumptions presented in the initial proposals appear challenging. In particular we note that several companies are being requested to reduce opex to leading quartile levels by April 2005 and deliver ongoing reductions of 2% p.a. The resulting compound rate of opex reduction seems to be well in excess of the 2.2% p.a. reduction advised in the CEPA report to Ofgem.

- **The proportion of the benefit/disbenefit of cost variances retained by companies.** We note that Ofgem intends to reduce the incentives, and therefore the proportion of benefit/disbenefit retained, for both opex and capex. Therefore, even if companies were able to deliver the same degree of out-performance as they have done in the current period they would be less rewarded.

We conclude that the combined return to investors of these proposals is likely to be less that in the current period, despite the marginal increase in WACC. Whilst companies will strive to out-perform regulatory assumptions, their ability to do so is limited by statutory, environmental and safety obligations, as well as the output performance targets and incentives set by Ofgem. Therefore, in determining the assumed cost of capital, Ofgem should not presume that investor's requirements would be satisfied, in part, by out-performance.

Tax Treatment

Under the post-tax approach to the cost of capital, a separate tax allowance is calculated to match the actual tax charge that each distribution business will face, unless there is a valid reason to the contrary.

As previously suggested, Ofgem has made its assessment of actual tax payable subject to a gearing adjustment in respect of the tax shield on debt. When calculating tax payable, Ofgem has stated that it will take the actual gearing level of each distribution business, or a 60% level consistent with the pre-tax cost of capital assumption – if that is higher.

We note that, in these proposals, Ofgem has made three further adjustments in its tax calculations of each entity:

- Parts of each company's capital expenditure are treated as if opex, on the grounds that this is consistent with Ofgem's cost analysis and also because the degree of capitalisation varies across companies.

- Incentive payments are assumed not to be taxable, because they represent additional revenue in excess of the underlying costs of running the business.

- Revenue allowed in the DPCR 4 period in respect of opex costs incurred in the DPCR3 period is assumed not taxable, as companies have already had the tax deduction in the previous period.

In respect of the first adjustment, two reasons are offered for not following the tax treatment, i.e. consistency with Ofgem's cost analysis and varying capitalisation practice across companies. Both these points seem associated with Ofgem's approach to cost analysis rather than the assessment of tax payable. Neither appears to offer justification for why the Inland Revenue's actual tax treatments should not be adopted.

In respect of the second adjustment, the reason given for not allowing tax on incentive payments is that incentive revenue is in excess of the costs of running the business. We believe that incentive regimes are an integral part of the regulatory framework for network utilities, and consequently that associated receipts and payments are a normal part of running the business, as are tax payments and credits on them. Therefore this tax cost should be considered as allowable.
In addition, we note that, if there were to be no tax allowance in respect of receipts under the incentive regimes, then neither should there by any tax credit assumed in respect of any payments expected to be made under these regimes.

In respect of the third adjustment, if its effect is to leave companies in the same position as if they had not needed to incur the extra expenditure, then it would seem a valid reason for departing from the actual tax charge expected to be payable.

<u>Financial Indicators</u>

Ofgem states that it considers "financeability" through the calculation and assessment of financial ratios. The paper sets out three financial indicators and their levels as follows:

- FFO / Interest — 3x minimum
- Retained cash flow to debt — 9% minimum
- RV gearing — 65% maximum

The paper states that certain companies breach some of the above ratios in some of the years 2005-2010, but that only one company has a major financing issue. Ofgem's initial view is that, because there is not a general constraint across the sector, it is reasonable to assume that shareholders would provide additional equity to this company.

NGT's major concern in this area is the lack of clarity. We believe it to be highly desirable that the following additional information should be set out within the next consultation paper:

- the minimum level of credit rating represented by the levels of financial ratios targeted (A-, BBB+ or BBB?). Logically the level targeted should be consistent with that assumed in the cost of debt; and

- the criteria Ofgem uses to assess a "major financing issue." For example, is this breach of more than one ratio for more than one year? Also, how are trends towards breach taken account of where, based on trends in the period 2005-2010, a breach would be expected in the following price control period?

We would also question the assumption that, if the financial modelling shows a major financing issue, then shareholders should inject equity into a business. Shareholders injecting cash into the business could solve any potential financial problem. Using this logic, the financial modelling does not act as a constraint, and therefore it is difficult to see what purpose it has.

In addition, the assumption that equity may be injected into the business needs to be within the constraints of the gearing assumption underlying the cost of capital assumption. To the extent that equity has to be injected to reduce gearing below the cost of capital assumption then the cost of capital itself will need to be adjusted.

Early Retirement Deficiency Contributions (ERDC)

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 assumptions when price controls are set. Prior to this Consultation Paper, Ofgem had suggested that companies pay for 100% of past use of surplus. 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.

In this consultation paper, Ofgem states that the treatment of these costs was not clear in previous price controls and that it was efficient for companies to have used surplus in this way. It also suggests that customers typically receive around 70% of the benefit of cost savings and so should fund 70% of ERDC costs.

We welcome Ofgem's acceptance that companies acted efficiently in using pension fund surplus, and Ofgem's recognition that consumers have gained far more than the companies from this practice.

As we have said in responses to previous Ofgem consultations, we do not believe it reasonable to retrospectively claw back any 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.

- Companies had a **basis for expectation** that ERDCs could subsequently be recovered from customers because:

    - Ofgem and Offer were aware from 1995 onwards that, for example, NGC was using surplus, but did not act, or even hint, that the practice was unacceptable or even undesirable in any way; and

    - Ofgem has not adjusted previous price controls to disallow the increase in pension costs caused by previous use of surplus (i.e. that caused through higher ongoing contributions from the following actuarial valuation)

Despite the strength of the above arguments, if Ofgem is determined to claw back some past use of surplus, however unreasonably, then one potential approach is, as Ofgem has suggested, to calibrate the claw back to the proportion of benefit which customers and companies have received from use of surplus. The consultation paper suggests that consumers typically received about 70% of the benefit from an opex saving and so should pay for 70% of the past use of surplus leaving companies to pay 30%.

We believe that, according to Ofgem's own numbers, 30% **overstates** the likely benefit gained by companies. Ofgem's May 2003 Consultation paper entitled "Developing Monopoly Price Controls" contains on page 25 a table showing the proportion of ongoing opex savings kept by the company. It shows that, with a five-year retention period, the maximum possible given a five-year price control, the company keeps 29% of the saving. In contrast, if a saving were made 1 year from the end of a price control period, the company would only keep 6%. The **range** of potential outcomes therefore is between **6% and 29%.** In the case of five-year price controls, if surplus were used evenly in each year, then 18% of the benefit will be attributable to companies. Ofgem has the data to calculate the number of years benefit obtained by each company's use of surplus, but 30% must be too high.

I would be happy to discuss any of the above issues.

Yours sincerely

by email

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