Electricity Distribution Price Control Review – Update Paper – September 2004

A Response by British Gas Trading

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EXECUTIVE SUMMARY

British Gas Trading (British Gas) welcomes the opportunity to respond to Ofgem's consultation in respect of the 'Electricity Distribution Price Control Review – Update Paper' and is happy for this non-confidential response to be placed in the Ofgem library.

Whilst we welcomed the broad thrust of Ofgem's Initial Proposals document, we are generally disappointed with Ofgem's Update Paper in particular the extent to which Ofgem now appears to have softened its stance on a number of key items. The more generous pension and tax allowances, easier operating cost efficiency targets and allowances together with the more generous headroom for capital expenditure will significantly increase the revenue allowances for all the DNOs. This Update is particularly unwelcome and does not appear to appropriately balance the needs of customers and DNOs.

We are surprised at the extent to which Ofgem has decided to relax its assumptions on opex allowances and in particular the easing of ongoing efficiency targets from 2% per annum to 1.5% per annum. This position appears overly generous when compared to Ofwat's recent Draft Determination where the regulator's allowance was significantly below that of the companies' submissions.

Similarly, with regard to capex we are surprised that generally the allowances have now been increased to be broadly similar to the companies' forecasts and for 6 actually increased by up to 105% of the DNOs' forecasts. The final capex levels are also now some 30% above existing expenditure levels. These are significant increases and we are disappointed that Ofgem has not included an efficiency factor to mitigate these increases.

We find Ofgem's decision both to reduce the opex frontier shift whilst at the same time omitting an efficiency factor for other costs impossible to reconcile with any of the available data and would urge a significant rethink.

The general weakening of Ofgem's stance and the increase in allowances will lead to a significant reduction in the DNOs' financial risk during DPR4. We firmly believe that this reduced risk needs to be reflected in the cost of capital (i.e. the allowed return) that the DNOs are allowed to earn and accordingly strongly urge Ofgem to adopt a cost of capital at the bottom end of its range i.e. 6% (pre-tax real) and believe that there is no justification for the cost of capital to be any higher than the 6.6% (pre-tax real) currently employed in the Update Paper.

We generally welcome Ofgem's update for the metering price controls. However, we have some strong reservations regarding the one-way door concept and believe that this will act as a serious deterrent for suppliers to enter into commercial agreements with new MOs if adopted before competition is adequately established. We recommend that Ofgem delays this decision until 1st April 2007 in line with the long term switch off of SLC 36 – 36C.

We are disappointed that despite repeated mention in British Gas' consultation responses and previous Ofgem commitment, Ofgem has singularly failed to address the important issue of asset disposals leading to DNOs being paid twice for the same assets. Consequently DNOs will receive unwarranted windfalls amounting to many tens of £millions. We urge immediate action on this issue in time for the final proposals or a firm commitment to address this issue retrospectively in due course.

DETAILED COMMENTS

Wherever possible this response uses the headings and chapter numbering used in Ofgem's document.

2. Metering

British Gas is a strong advocate of the development of metering competition and has committed significant resources in moving the agenda forward. Our commitment stems from the belief that if Ofgem successfully creates a market that encourages new entrants, consumers will be the ultimate beneficiaries with higher service levels, innovative products and lower charges.

Following our generally negative view of the Initial Proposals document, we now consider Ofgem's update for the metering price controls to be more positive and in particular welcome the considerable development of the methodology employed to derive both the prospective MAP and MOp charges though there is a challenging timetable to complete the proposals. Though we do not believe that premature replacement of assets will be a problem in electricity based on our experience of the gas market, we fully support the need to prevent DNOs levying termination charges, as the use of such a charge appears to be an anti-competitive device.

However, we continue to have some strong reservations regarding a number of accompanying issues.

Firstly, regarding the proposed one-way door, we believe that this will act as a serious impediment to the development of competition as it will deter suppliers from entering into commercial agreements with new MOs. Whilst we appreciate the need for the removal of licence obligations we urge Ofgem to consider delaying this decision until 1st April 2007 in line with the long term switch off of SLC 36 – 36C on the proviso that competition is adequately established.

Secondly, regarding the provision of basic services, our concern relates more to Metering Standards of Performance rather than whether the existing contracts are sufficiently robust to maintain the mix of appointment times assumed in setting the price control. Even since before the introduction of the Metering Standards of Performance on suppliers in April 2002 British Gas made Ofgem aware of our concerns in this area. We are concerned that any weakening of the current requirements around appointments will lead to further exposure for suppliers who are under obligation to provide certain regulated levels of service to customers via the JPW (Joint PES Working) Agreements with DNOs. We would also be concerned if the fixing of the basic services as at 1st June 2003 triggered any contract variations from DNO MOs to reduce the levels of service provided.

Thirdly, with regard to the revenue driver for MOp, we are agnostic as to the variable used and believe that this will be best identified through regression analysis. We do however urge Ofgem to carry out a sense check on the resultant fixed element to ensure that this is set an appropriate level. Further, we question the rationale of providing an additional 1.5% mark-up on costs that have been derived from the 60th percentile of competitive data that, by default, will already include a competitive mark-up (profit/return) on competitive costs.

We believe that there is little to warrant such a double counting approach unless the main price control revenues are reduced by an equal and opposite amount.

We are surprised that Ofgem appears to believe that good regulatory practice with regards to transparency can be satisfied by the paucity of information provided in relation to the MOp revenue cap. It is not possible for us to comment on whether or not the level of MOp charges are likely to be at an appropriate level, in particular whether or not the charges will allow competitive entry, as Ofgem has not provided any breakdown of activities and their unit costs. All previous regulatory practice, Ofgem's and other regulators', has included a significant level of transparency in relation to the setting of price control revenues even where the price controls are being set for activities that are subject to competition from new entrants, Ofgem need only review its own previous approaches to the setting of the electricity and gas supply price controls. The Ofgem statement "Ofgem is not proposing to publish the break down of activities and the DNOs' responses as these are commercially sensitive in nature" is very poor regulatory practice and based on a falsehood respectively.

Finally, regarding MAP, we seek Ofgem confirmation that there has been an adjustment to the main price control RAV equal and opposite in NPV terms to the metering RAV being created using the proposed methodology.

3. Quality of service and other outputs

We are generally supportive of the proposals though we still await Ofgem publication of the DNO specific historical adjusted losses performance data to allow us to verify the losses targets being set.

4. Cost Assessment

Regional factors

DNOs' geographic boundaries do not constrain the location of many of their staff consequently regional wage and property indices are likely to be a poor indication of DNO specific operating costs hence the need, if any, for regional cost allowances. Some of EDF's distribution activities have been located outside of their distribution areas for some years. Moreover, since the mergers of EPN, LPN and SPN many activities appear to have been moved within the combined service areas to the relatively low cost regions. In particular there has been a steady movement away from the higher cost London sites.

We are unsure how Ofgem arrived at the LPN regional allowance; we would like greater transparency and justification as to the derivation of this amount as it appears large in light of our earlier comments. Moreover, we would urge Ofgem to strongly resist arguments for other DNO-specific allowances.

Establishing a benchmark

For the reasons stated in previous responses we believe that the use of upper quartile costs strikes an appropriate balance between setting costs at the efficient level whilst at the same time avoiding the use of an erroneously low frontier. Consequently, we would strongly urge Ofgem to resist DNO arguments for the use of average costs.

Glidepath

We agree with Ofgem's arguments for not using a glidepath.

Frontier shift

We are surprised by the reduction of the ongoing efficiency targets from 2% per annum to 1.5% per annum. The content of Ofgem's consultants' report (rather than its erroneous conclusions) would support a much higher rather than lower figure. Moreover, when the 1.5% opex efficiency factor is combined with a zero efficiency factor on DNO's other costs (capex) and if account is taken of the fixed frontier until 2006/7, DNO efficiency in aggregate is in effect expected to improve by a small amount.

A stylised version of our thinking is given below:

Assume base year opex costs are 100, hence opex revenues in 2005/6 will be 100, apply 1.5% p.a. opex efficiency factor from 2006/7 onwards (i.e. no frontier shift until fourth year after base year) with no efficiency factor on any other costs.

		DPC3			DPC4					
		Base year 2002/3	2003/4	2004/5	2005/6	2006/7	2007/8	2008/9	2009/10	Total
Ofgem's proposals	Opex	100	100	100	100	98.5	97.0	95.6	94.1	785.22
	PFP - opex	0	0	0	0	1.5	1.5	1.5	1.5	
	Capital	300	300	300	300	300	300	300	300	2400.0
	PFP - Capital	N/A	0	0	0	0	0	0	0	
	Total costs	400.0	400.0	400.0	400.0	398.5	397.0	395.6	394.1	3185.2
	TFP	N/A	0.00	0.00	0.00	0.38	0.37	0.37	0.36	
Ofgem equivalent proposals	Opex	100	99.5	98.9	98.4	97.9	97.4	96.9	96.3	785.32
	PFP - opex	N/A	0.53	0.53	0.53	0.53	0.53	0.53	0.53	
	Capital	300	300	300	300	300	300	300	300	2400.0
	PFP - Capital	N/A	0	0	0	0	0	0	0	
	Total costs	400.00	399.47	398.94	398.42	397.90	397.38	396.86	396.35	3185.3
	TFP	N/A	0.13	0.13	0.13	0.13	0.13	0.13	0.13	

The table above shows "Ofgem's proposals" followed by the overall effective efficiency factor implied by those proposals, i.e. "Ofgem equivalent proposals". The table shows that Ofgem's 1.5% opex X-factor equates to an overall frontier shift of 0.13% p.a. for total DNO costs. This is lower than the performance of any utility over any time period since privatisation because of the continuation of the post-privatisation effect.

Even in water, an industry where unlike electricity future efficiency improvements are expected to be difficult to achieve, Ofwat intends to use efficiency improvements of 2.6% for water and 3.9% for sewerage.

We find Ofgem's decision both to reduce the opex frontier shift whilst at the same time omitting an efficiency factor for other costs impossible to reconcile with any of the available data and would urge a significant rethink.

Following our discussions with Ofgem and a further review of Ofgem's consultants' DNO efficiency report, we note that CEPA's reporting of capex efficiency is misleading within the context of X-factors. The report assesses the overall improvement in capex efficiency in a pretty standard manner. However, the relatively low reported capex efficiency numbers cannot be used directly to attach an X-factor to capex allowances (as would be the case for opex efficiency assessments) as only a small proportion of the asset base is being replaced in any one year. The capex efficiency factor has to be adjusted to take account of the proportion of the asset base being replaced, this results in a significantly higher X-factor for capex than is apparent from CEPA's report.

Mergers

Though theoretically compelling the actual evidence for the advantages of mergers in the general economy is somewhat mixed and as Ofgem indicates the evidence for the value of a merger in the DNO sector is far from certain. We would strongly oppose giving single DNOs any arbitrary additional allowance as this would be as inequitable as reducing merged entities' allowances by an arbitrary amount. In light of the uncertainty it is best to proceed without any adjustment for merged / single entities.

As part of the Transco DN disposal discussions, we employed Oxera to produce a model to estimate the value of comparators that we have also shared with Ofgem. Ofgem and its consultants have subsequently adopted most aspects of this methodology. We have subsequently refined this model and we are happy to share this work with the Ofgem price control team.

General Comments

We are surprised at the extent to which Ofgem has decided to relax its assumptions on opex allowances, increasing them by 8% from the Initial Proposals, so that in the majority of cases they are equivalent to the companies' own forecasts. This is at odds with all previous experience across all the regulatory bodies.

Similarly, with regard to capex we are surprised that, with the exception of the EDF group of companies, the allowances have now been increased to be broadly similar to the companies' forecasts and in 6 actually increased by up to 105% of the DNO forecast. Capex allowances are also expected to be some 30% higher than current expenditure. These are significant increases and we are disappointed that Ofgem has not included an efficiency factor to mitigate these nor has Ofgem published any information to substantiate the increases. This appears to be a major regulatory failure and flies in the face all previous practice. We reiterate our request for Ofgem justification of the capex allowances. Once again we remind Ofgem of the considerable capex efficiencies that water companies are expected to deliver over their forthcoming price control, namely 17.4% in water capex and 20.7% in sewerage.

5. Financial Issues

The cost of capital

We understand that for the Update Paper, as with the Initial Proposals, Ofgem's modelling assumptions have been based on a 6.6% pre-tax cost of capital, this being the mid point of the proposed range of 6% to 7.2% and that a final decision will be made in November.

In our response to the Initial Proposals we noted that in our view there was no compelling evidence to justify a higher cost of capital. On the contrary, current market data points to a lower cost of capital with downward pressure from the risk-free rate, debt premium, gearing and equity β, offset by upward pressure from the equity risk premium.

We see Ofgem's Update Paper as materially reducing the upward pressure on the cost of capital even further with the increased allowances significantly reducing the risk companies now face, this is especially relevant with respect to the additional pension allowances of £70m.

We also understand that Ofgem is being more generous on return on equity than the data would suggest. Although the headline cost of capital in the Initial Proposals only increased by 0.1% over the level allowed for the 2000-05 price control, gearing levels are higher than assumed at the last review and debt costs have fallen. As a result, the return on equity implied by Ofgem's 4.6% is 7.25% - 125 bps - higher than allowed at the last review.

We understand that several DNOs argue that the cost of capital should be closer to that adopted by Ofwat in the Draft Determinations where it has proposed a 5.1% post-tax (or 7.3% pre-tax) cost of capital. We would however reiterate our view that this increase is driven primarily by the requirement for companies to undertake large capital programmes that will result in persistent negative cash flow. This can lead to deterioration in credit quality that could restrict companies' access to capital markets or significantly increase their cost of finance. Consequently, Ofwat's draft price limits include around 0.5% for 2007/08 rising to 1% by 2009/10 to maintain finaceablity. These constraints do not present themselves in DPCR4.

In conclusion, the general weakening of Ofgem's stance and the increase in allowances will lead to a significant reduction of the financial risk that DNOs will be exposed to during DPR4. We firmly believe that this reduced risk needs to be reflected in the cost of capital (i.e. the allowed return) that the DNOs are allowed to earn and accordingly strongly urge Ofgem to adopt a cost of capital at the bottom end of its range i.e. 6% (pre-tax real). Under no circumstances is there any justification for the cost of capital to be any higher than the 6.6% (pre-tax real) currently employed in the Update Paper.

Pensions

We are disappointed by Ofgem's reversal of its decision to make no adjustment for Early Retirement Deficiency Costs (ERDC), as we consider it is reasonable to expect companies to absorb any increase, or retain any benefit of any decrease, in the cost of providing enhanced pension benefits granted under severance arrangements that have not been fully matched by increased contributions.

Tax

We understand that tax charges are expected to rise from 2005/06 with the end of the non-load agreement and that the Update Paper adopts a more neutral view on DNOs' ability to re-optimise their tax positions that has resulted in an increased allowance of £90m for tax costs. We are disappointed by this change, as it seems to reflect an unwelcome reversion to the current approach where Ofgem has used marginal tax rates rather than an assessment of the efficient tax rates. This has meant that many DNOs have been able to consistently outperform Ofgem's assumptions. Moreover, out-performance of marginal tax rates has never been captured at successive reviews. We understand that Ofgem will aim to share any efficiencies with customers, although we are concerned that the exact mechanism for this has yet to be consulted on.

Regulatory asset value

We are disappointed that despite repeated mention in British Gas' consultation responses and previous Ofgem commitment, Ofgem has singularly failed to address the important issue of asset disposals. It is our understanding that DNOs have made significant asset disposals, particularly property, either as a consequence of general corporate transactions or as part of the Utilities Act Transfer Scheme where assets were 'left behind' in other related companies. All previous regulatory practice, in particular, significant precedent set down by successive Monopolies and Merger Commission (the Competition Commission's predecessor) enquiries including the "focused versus unfocussed" decisions means that these asset disposals should be identified and the regulatory asset bases reduced accordingly. The effect of this change would be to allow customers as well as shareholders to benefit from the increased DNO efficiency. Failure to achieve this objective would imply a major regulatory failure, as DNOs would have been paid twice for the same assets. Consequently DNOs will receive unwarranted windfalls amounting to many tens of £millions. We urge immediate action on this issue in time for the final proposals or a firm commitment to address this issue retrospectively in due course.

Other issues

It is our understanding that an unwarranted windfall for DPC3 out-performance, as noted in our previous responses, for those DNOs with accelerated depreciation in DPC3 appears to be intact. We would urge Ofgem action on this.

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