Ofgem's Initial Consultation on TPCR4

Comments by E.ON UK

The following detailed comments are structured to follow the order of Ofgem's document.

1. Framework for the price control

Incentive regulation is the best way to protect customers

RPI – X has provided incentives for companies to deliver statutory and licence obligations at least cost, and in the process has resulted in significant productivity gains and reductions in customer prices. Asset management techniques have advanced significantly since privatisation, which has increased asset lifetime, and therefore contributed to improvements in efficiencies. We agree that incentive regulation is the best way to protect customers, but it is important that it strikes an appropriate balance between the interests of current and future customers. We believe this will require greater incentives to invest than at present, together with a more stable and certain framework for the longer term.

Framework for transmission and distribution should be consistent

There are many areas where in principle the framework for transmission and distribution should be consistent. They include the approaches to setting the cost of capital, the power of the incentives for opex and capex, and the type of costs that should be incentivised or passed through to customers. However the framework cannot be fully harmonised as there will be factors that are specific to transmission which will require unique solutions. For example, the pass through of the transmission asset owners' allowed revenues by NGC (4.31) should incorporate an efficiency adjustment to allow for efficiencies gained by operating three individual networks as one entity, assuming this is not taken into account elsewhere. Where this is the case, a one-size-fit-all approach would neither be in the interests of customers nor the network companies.

Ofgem will use a range of techniques and methods for assessing efficiency and projecting future costs

We have consistently advocated the use of a number of different approaches for assessing efficiency, and welcomed the CEPA report on Benchmarking in 2003 that endorsed this

view. There is the risk of significant modelling error in both distribution and transmission because of the limited number of companies and the comparability of their cost base. Using a range of techniques to inform views on efficiency, rather than relying exclusively on a single methodology such as regression will help to mitigate some of the modelling risk, and is consistent with adopting a pragmatic approach for projecting future costs.

Ofgem will seek to use 5 year rolling mechanisms for opex and capex

RPI – X regulation theoretically provides strong incentives to encourage companies to pursue cost efficiencies. However, for distributors, the benefits from operating cost efficiencies are only currently retained for the duration of the price control. The incentives to make savings are likely to diminish through time, making it more attractive to undertake these in the first couple of years of a price control. For example, a company retains 27% of the present value of an opex cost reduction made in the first year of a price control period and only 6% of the present value of a cost saving made in the fifth year[1].

Year of saving	1	2	3	4	5
% of perpetuity value	27.0	22.3	17.2	11.8	6.1

Some investment decisions that could lead to further opex savings towards the end of a price control period may therefore be delayed as a reaction to a declining pay back period. This is not in the interest of consumers in the long term as it would lead to higher prices than would arise under a rolling mechanism. The same principle applies to capex, but this has been addressed by Ofgem by maintaining a 5 year rolling mechanism for distributors. We therefore support the principle of rolling mechanisms for both opex and capex to remove timing distortions that would otherwise occur in the regulatory timetable.

Cost of capital will be calculated in a transparent way, using forward looking market data where appropriate

We welcome Ofgem's approach of calculating the cost of capital in a transparent way. In applying the CAPM model, care must be taken to ensure that the recent high volatility of the stock market does not lead to incorrect conclusions. Whilst forward looking market data is one source of information for determining the right cost of capital, there is a significant risk of investment under-funding should the cost of capital be set too low.

[1] Based on analysis in Frontier Economics' Report "Balancing Incentives" - http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/2488_FrontierIncentivesReport_march14.pdf

Whatever the outcome of any theoretical cost of capital exercise, it is important that the cost of capital is set at a level which encourages companies to invest in the networks, and maintains companies' abilities to source appropriate financing. In particular, if the cost of equity is set too low, then companies will be forced to finance investment in the network through an increasingly high proportion of debt.

High levels of gearing need to be discouraged because:

- they lead to an increased risk of systemic failure;
- high debt levels reduce the financial flexibility of companies to respond to unforeseen circumstances;
- there is a higher probability of financial strain that could put at risk any investment programme; and
- a low proportion of equity weakens incentives for innovation and risk taking, which is not in the interests of customers over the medium and longer terms.

Pension guidelines as used for distribution will also be applied to transmission

The pragmatic guidelines used by Ofgem in setting the pension allowance for distributors should also be applied to transmission, and so we welcome Ofgem's current intentions. Customers have seen the benefit of lower charges in the past resulting from pension surpluses and holidays. The pragmatic approach applied in DPCR4 was a means of providing balance in the current review period, with shareholders bearing some of the resulting costs of the pensions fund deficits. However, in subsequent price controls, the full pension cost (excluding the issue of ERDCs) should be passed to consumers provided it is efficiently incurred.

Established RAV approach will remain

The RAV is used by Financial Institutions to value companies. We do not believe that this should change in the immediate future. The approach of allowing efficient capex to be rolled forward into the RAV is sensible and we welcome Ofgem's view of continuing with this framework. If the current approach, which is widely understood by financial institutions, is changed, it will increase the uncertainty of the regulatory framework and also raise the level of regulatory risk perceived by the City.

Feedback to industry

We welcome the affirmation in paragraph 4.9 that Ofgem will build on experience and feedback from the DPCR4 process in making sure that the proposals under the transmission price control review are well understood and transparent to all interested parties.

2. Incentives for performance

Should Ofgem maintain this approach to incentives, and if not, how should the RPI-X model be further refined?

We are broadly supportive of the incentive regime set out in the paper. However we note from the DPCR 4 review that for the information quality incentives to work effectively, it is important that the rules are clearly defined upfront. Therefore if a sliding scale approach is to be employed for transmission companies, this should be announced before the companies submit their Business Plan Questionnaires (BPQs).

One of the issues surrounding the sliding scale approach is the reliance on the accuracy of the underlying capex modelling undertaken. If the modelling is not sufficiently robust, then the incentive properties of the sliding scale are significantly reduced. This issue can be addressed by ensuring that the modelling process undertaken either by Ofgem or external consultants is transparent. During the last distribution review, there was a lack of understanding amongst DNOs of the PB Power model. The limited transparency contributed to our concerns over the robustness of the analysis conducted. Increasing the transparency of the modelling in the future will, in our view, have a positive impact upon such analysis. All parties will understand how the results have been formulated and allow constructive discussion about the conclusions.

Where there is little uncertainty over the magnitude of the impact of an event, it is appropriate to incorporate a specific mechanistic term within the price control formula to incentivise companies, provided there is sufficient correlation between the term and the incremental costs caused by a change in outputs. However where there is uncertainty over the scale of the impact, a mechanistic approach would not be applicable. In these circumstances, a price control re-opener would be a more appropriate way of dealing with this uncertainty.

Should incentives to reduce costs be increased or weakened?

Since privatisation, the industry has been very successful at removing inefficiencies under an incentive framework. Customers have benefited over this period but the ability to

continue to make future savings is becoming more difficult to identify and costly to achieve. If consumers are to continue to receive benefits in the future from increasing efficiency then the framework needs to change to reflect this issue and incentivise companies to continue to progress. There are a number of way this could be achieved, such as through the application of a rolling 5 year (or more) mechanism complemented by an average cost approach. The latter in particular would also mitigate the risk of setting unsustainable cost allowances going forward.

Should opex and capex incentives be equalised?

The Frontier Economics report on balancing incentives[2] highlighted that the incentive to reduce operating costs is greater than the incentive to reduce capital costs. We accept that this has been a problem in the past, due mainly to the lack of a robust boundary between the two cost categories. This problem could be addressed by equalising the opex and capex incentives, but we do not believe this is in the longer term interests of customers as it would lead to lower operating efficiency savings. Our preferred approach, which Ofgem adopted for DPCR 4, is to set up a cost reporting project designed to overcome many of these issues. We strongly advocate a similar approach for transmission, which must ensure that the boundary between opex and capex is clear and consistently applied. Maintaining strong opex incentives by retaining differential incentives for opex and capex and ensuring that the cost categories are clearly defined, will encourage further opex efficiencies to be obtained and protect the interests of customers.

3. Objectives for the review

We support the objectives set out in the paper for the transmission review. However we believe that a fifth objective should be added. The review should seek to ensure that the transmission companies can finance their licensed activities commensurate with an efficient level of expenditure. This was an objective for the distribution review, and we believe that it should also become an objective for the transmission review.

[2] http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/2488_FrontierIncentivesReport_march14.pdf

4. Assessing costs

Ofgem seeks views on what areas of operating costs Ofgem should focus its efficiency assessment on?

As discussed above, experience in the past Distribution Price Control Reviews (DPCRs) has shown significant issues with the boundaries between opex and capex, which are remunerated differently. As part of the Transmission review, Ofgem must decide under which category costs (e.g. repairs; indirect costs etc) are to be remunerated and enforce those definitions and boundaries in monitoring performance. However, unlike Distribution, Ofgem should seek to review the drivers for capitalisation of indirect costs in order to establish a sustainable methodology rather than apply an arbitrary % split which creates perverse incentives on companies. Similarly, Ofgem should review the consistency of those drivers, and those for allocating shared costs to each of the businesses within a group, both across time and between companies.

Having defined suitable boundaries, more robust comparisons can be made as to efficiency improvements made by companies. However, caution should be taken in making direct comparisons between companies, particularly with DNO activities. The recent DPCR revealed considerable differences in companies' costs, driven by issues such as corporate structure; sourcing strategies; and accounting policies. Whilst the industry has worked hard since the conclusion of the review to report costs at a disaggregated level on a more consistent basis, early analysis would further expose the extent of the problem in seeking to compare companies on a robust basis.

Ofgem seeks views on the cost assessment approaches and whether there are any other possibilities for assessing efficiency?

The recent experience of the distribution price control review showed that there were significant differences between companies in the way they report costs at the disaggregated level. A robust cost reporting framework will go some way to addressing this matter, but as we have discussed, some problems still need to be resolved. Given the progress that is still required to make meaningful comparisons on a disaggregated basis between distribution companies, we believe any comparison of costs at the activity level between transmission companies must be treated with caution. Using the results mechanistically would increase the risk to these companies when the data is not necessarily consistent and hence differences may not be due to genuine inefficiency. Moreover without

careful application, there is the danger of creating a "virtual company" from the analysis based upon best practice within each activity. The creation of such a benchmark would lead to the setting of unsustainable cost allowances and place significant risk on the financial viability of the business.

Ofgem is also considering making comparisons between distribution and transmission companies at the disaggregated level. The problems that we have just highlighted would be magnified if Ofgem were to adopt such an approach. Before such a comparison could be made between industries, it would be important to ensure the analysis could be robustly produced within each industry. We are still some way from this, however even when separate industry analysis is sufficiently credible, there would still remain significant normalisation issues to address such as the choice of cost drivers applicable to both industries before an appropriate comparison could be made.

In theory, international benchmarking is one way of addressing the argument of having only a limited number of comparators. However whilst this would significantly increase the number of independent number of observations, the fundamental concern of ensuring that comparisons are being made on a like-for-like basis would remain, unless there were to be a European or International Cost Reporting Project. Even then, there is no guarantee that a genuine like-for-like comparison can be made for the reasons articulated above for the UK.

Overall there is very limited opportunity for conducting benchmarking of transmission companies, but where it is used, the principle should be that it is used only to inform views, rather than being used mechanistically. One possible way forward is to compare trends in efficiency improvements between distribution and transmission companies at the aggregated level to inform possible ongoing efficiency assumptions.

Ofgem seeks views on what cost reporting framework should be developed for monitoring performance over time?

As discussed above, past DPCRs have constantly been fettered by the inconsistency and incomparability of cost data, both in terms of accounting and company structure. There is a considerable risk going forward that as achievable efficiency gains begin to plateau, these structural issues will increasingly account for perceived differences between companies, rather than genuine differences in efficiency.

The cost reporting framework currently being developed in distribution provides an excellent opportunity to collect consistent information on a more disaggregated basis to

monitor performance against the price control and better understand the cost base of each licensee. However, the completion of those tables for the current year has revealed the extent of the differences between companies. Realistically, reasonably robust information will only be achievable closer to DPCR 5, although limited use can be made prior to then, both in comparing DNOs with each other and activities common with transmission. Additionally, we do not believe the disaggregated activity analysis is comparable due to the different resourcing strategies and company structures employed across the industry. To do so would generate a significant risk to both the industry and consumers in creating a virtual company which is not sustainable.

How should Ofgem assess capital expenditure?

In order to establish a fair comparison between the capital requirements of different companies, it is clear that some form of independent modelling is required. However, the DPCR 4 modelling undertaken by PB Power indicated a level of investment that was somewhat below the true requirements of the networks. Further work should therefore be undertaken to validate the assumptions and methodology within the modelling to ensure that it more accurately reflects the companies' actual requirements. Increasing the transparency of the modelling as we have argued above will go some way to resolving this concern. It would allow companies to understand the basis on which the capex allowance is being made, and also provide an informed critique of the model.

5. Incentives for incremental investment

How should baseline and incremental outputs be defined, and how should incremental outputs be incentivised?

During the recent distribution review, the assumptions supporting the Base Case submissions were based on the concept of maintaining existing risk levels. Although this concept was used by PB Power to support the conclusions of their modelling, there was no methodology in place for establishing the level of risk. This meant that it was not possible to establish how a reduction in risk in one area might offset additional risk in another, or how the absolute risk may have varied between companies.

The need to consider risk occurs primarily when evaluating proposals for work on the EHV networks. The relatively low number of assets and the redundancy built into network design mean that there is little or no change in actual network performance as a result of

either load or non-load investment. The use of risk in those circumstances is, therefore, valid but in order for it to have some meaning, a common method of establishing risk needs to be established and agreed between Ofgem and the companies.

Producing an agreed methodology for establishing risk is likely to involve a significant workload but E.ON UK would be eager to be involved in any work in this area that would lead to a process for justifying investment to maintain existing risk levels or, potentially, establishing a metric for network improvement incentives.

PB Power report

In order for the sliding scale approach to operate as was intended, the results of PB Power's modelling must be available for analysis and challenge in advance of Ofgem's initial proposals. This will not only require the results of the modelling to be available earlier in the review process, but will also require that the companies have greater visibility of the assumptions and methodology employed so that effective challenges can be made.

6. Finance issues

Ofgem intend to use a post tax cost of capital

We support Ofgem's intention of using a post tax approach for setting the cost of capital in transmission. It will be necessary to make full compensation for tax costs and these should be assessed on an individual company basis. The tax allowance should be based on the position of the licensed entity as if it were taxed on a standalone basis, a principle applied by Ofgem to distributors.

Maintaining an appropriate level of equity to finance the investment programme will require Ofgem to set a sufficient rate of return, especially since UK networks are competing in a global market for capital. We believe that the capital markets will focus on real world factors such as the long term increase in levels of investment, cash negativity, financeability ratios, reducing opportunities to outperform the price control as well as comparative rates in other utility sectors.

In order to attract long-term equity investment to support forthcoming capital programmes, we believe the principles used for setting the distribution cost of capital should also be applied to the transmission companies. Consistency should be applied across the

industries, but there is also the scope for transmission specific factors to be incorporated within the methodology for setting the cost of capital.

How should the RAV be rolled forward into 2007?

NGC has significantly overspent the capex allowances over the past five years. These are predominantly due to factors outside of its control. The principle that should be used in deciding how much capex should enter the RAV at the start of a new price control is whether the investment has been incurred efficiently. So long as this can be demonstrated by the company, the investment undertaken in excess of the original allowance should enter the RAV. To do otherwise would unfairly penalise the actions of an efficient company responding to changing circumstance to those assumed when setting the original price control. However where it cannot be substantiated that overspends have been efficiently incurred, then a sliding scale approach may be more appropriate thus allowing for the sharing of these costs.

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