

Central Networks

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Transmission Price Control Review

Dear Robert

The decision by Ofgem to harmonise all of the Transmission price controls has been welcomed, and has enabled Central Networks to comment on issues that are applicable to all parties concerned.

There are a number of challenges facing the industry over the coming months and years, not least the issues that are being discussed during the Government's Energy Review. Against this background, we have reviewed the consultation response and have made comments in areas where we believe we can be constructive during the Transmission price control process.

I trust that if you have comments from any points we have made in our attached paper, then you will feel free to contact me.

Yours sincerely

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Response to the Second Transmission Price Control Review

3.20 – 3.28 Objectives of the review

We support the objectives of the transmission price control review, and welcome the explicit reference regarding the need for the Authority to (i) ensure that licensees can finance their licensed and statutory obligations and (ii) apply principles that represent best regulatory practice.

4.21 – 4.30 Operating Costs

The intention of Ofgem to use a package of approaches for undertaking comparative analysis of operating costs is a sensible approach to how benchmarking results should be used to inform the setting of future allowances. Given that no one benchmarking technique is perfect, our experience suggests best regulatory practice should not rely predominantly on one particular analytical tool. We would encourage Ofgem to apply these principles to all future price controls.

5.16 – 5.20 Re-openers

The principle that should be adopted for regulating network monopoly businesses is that where costs can be foreseen with some certainty, and are under management have control, they should be incentivised to ensure they are efficiently incurred. The RPI-X methodology has been successful at removing inefficient costs from monopoly businesses. However it is inappropriate for management to bear costs where there is significant uncertainty, or where they do not have control over their imposition. In those situations (e.g. a change in primary legislation), we believe that where an automatic adjustment mechanism cannot be robustly implemented, the costs should be passed through to customers. This will inevitably involve some type of re-opener, similar to that set out in the DNO licences, which involve the introduction of new costs that were not built into the cost base, and brought about by new legislation and standards.

5.39 – 5.47 Rolling incentives

Where opportunities to make savings are identified, they should be pursued by management, leading to lower long term prices to customers. The longer these savings are retained by shareholders, the more likely it is that efficiency initiatives will be introduced on economic grounds to the benefit of customers. This is even more of an issue as the era of cheap or costless savings programmes has now come to an end. The application of a rolling incentive regime for opex and capex will ensure that there is no discrimination between making efficiency savings in the first year of a price control compared with the fourth or fifth year of that price control.

Moreover it would be supportive of efficiency saving programmes that generally incur significant upfront costs, but provide ongoing benefits to customers. We believe that rolling incentives could also be used to inform the setting of operating cost allowances, especially in circumstances where either (i) there is uncertainty over the benchmarking analysis or (ii) the industry has sufficiently converged.

5.32 – 5.38 Sliding scale mechanism

The principle of a sliding scale mechanism to inform the setting of capital allowances is supported by Central Networks. Our experience of DPCR 4 is that the methodology allows companies some degree of flexibility in the way they manage risks on the network. Where there is analysis subsequent to a review in support of spending above the allowance, this mechanism may provide for this incremental investment. However, it should not dilute the requirement for Ofgem and the companies to understand and agree a proper level of Capital investment that is appropriate for reinforcement and replacement of the network assets. We would be extremely concerned if there was not sufficient focus on the accuracy of future capex requirements because of the flexibility provided by the sliding scale mechanism.

5.48 – 5.53 Performance indicators

The application of well designed performance based incentives can be effective in influencing companies' strategies, and for aligning these with the interests of customers. However the incentive mechanism must be driven by outputs that can be controlled and measured by the companies. Output measures that are subject to influences that are outside the companies' control introduce uncertainty and business risk that can only be mitigated by sub-optimal investment strategies. Where a robust output measure is difficult to define, but improvements are nevertheless sought, for example resilience, an input measure based on an 'Investment Contract' between Ofgem and the companies may be more appropriate.

6.1 – 6.19 Price Control design options

We believe it is appropriate for Ofgem to be considering alternative options to the traditional "pure" revenue cap approach. Over the coming years, increasing investment in energy infrastructure will have to take place. This will require a careful balance of the risks between the players in the energy market, if infrastructure investment is to be delivered in a timely and efficient manner. For network owners and operators, a framework that provides appropriate signals for investment is needed for innovation, for example in achieving renewables targets. However, if this framework is too

mechanistic or too rigid, policy objectives on security of supply or renewables targets will become harder to achieve.

Prospective network users' projects are already likely to incorporate a significant degree of risk in terms of seeking planning consent (this is particularly true for renewables) as well as normal "price" risks. Adding to the overall level of project risk by requiring a long term financial agreement to be put in place before consent has been granted may mean that some projects cease to materialise, thus compromising security of supply or environmental objectives. Conversely, not signing a longer term agreement until after consent had been achieved and the project started would lead to unnecessary delays and increased costs, which would ultimately have to be passed to the consumer.

Risk sharing agreements should be capable of being tailored to the individual situation. This process should take account of available network capacity, other actual and anticipated demands for connection and the "business as usual" need to reinforce and upgrade the network for maintaining secure supplies, viewed within the context of national objectives relating to security of supply and renewables. We believe that a more flexible alternative should be explored – namely something that is a hybrid of the "user commitment" and "de-regulated revenue" model. The principles that should be adopted are (i) there are sufficient signals to invest and (ii) there is a fair balance of risk between all parties.

9.5 – 9.8 Financing investment

Our overall philosophy to the approach to financing investment is that a climate must be created that enables a business to decide on the appropriate mixture of debt and equity. To have this flexibility requires investors to be sufficiently attracted to inject equity into the business. This is beneficial for customers as a reliance on debt to finance an ever increasing investment requirement on network businesses over the coming decades will increase the risk profile of these businesses and damage the incentive properties placed upon business managers.

We believe there are a number of necessary ingredients required to achieve this desired outcome. They all stem from the financing community requiring long term certainty in decision making, especially since investment decision that are long lived overlap a number of price control periods.

The financial community will therefore want to understand the approach that will govern the regulatory framework over a period of time in exchange for being willing to invest in this sector. This is aided by Ofgem taking robust and consistent positions and applying a logical rationale that would avoid unforeseen decisions and the consequent damage and confidence this has on investors. We would point to a number of areas where by its own actions, Ofgem can increase or reduce confidence, including the approach taken for setting financial indicators, regulatory depreciation policy and the cost of capital.

Where a particular policy is justified at one price control, and then subsequently reversed in the following review, stability is not provided. This would lead investors to question the long term position of a policy even where Ofgem intended that the decision should improve the overall investment climate. Stability is therefore a crucial factor in ensuring that at least a proportion of the growing investment requirements is not financed by debt.

Turning to the question of how lumpy investment should be financed, we believe that the use of depreciation is still merited and allows investment to be smoothed over a period of years. The impact this will have on prices, not just in the current period, but in future price controls will need to be assessed with other key parameters. This can be achieved by sculpting the price profile over a number of price controls in a fashion that provides an appropriate balance of Po and X, given the longer term view of investment, operating costs and revenues.

9.12 – 9.17 Cost of capital

The current capital programme increases the operational gearing of network businesses, which will only gradually feed through to market beta data. Furthermore we believe that competition for financing and in particular recent attractive returns from the UK stock market means that for network financing to be attractive, a reasonable cost of capital must be allowed. Our view therefore remains that the cost of capital must be set above any range which results from the application of current market data to the capital asset pricing model. We look forward to Ofgem's review of the cost of capital and will contribute to this debate over the coming months.

9.19 – 9.22 Tax

We supported Ofgem's approach to setting tax allowances during the recent distribution review and believe that a similar approach be applied to transmission companies. Both customers and shareholders benefit from

incentives to minimise the tax burden facing these businesses, and as such believe ex-ante tax allowances should also be set for transmission companies.

9.23 – 9.30 Gearing

There is very limited evidence pointing to the sustainability of gearing levels above those currently assumed for network businesses. We believe that the approach to gearing should be consistent with ensuring that sufficient levels of equity are invested in the electricity and gas networks as we have argued above. Incentives on management to continually improve will be strong where there is a significant equity presence, and a tax and gearing policy as introduced for the electricity distribution networks will mitigate the pressures on the balance sheet at a time of rising investment. Avoiding financial distress is in the interests of customers, and an appropriate gearing policy we believe can be supportive of this objective.

9.31 – 9.33 Depreciation

Electricity transmission companies will be facing the same depreciation “cliff face” challenge as that which faced DNOs during the last two distribution price control reviews. The short term solution which was applied to DNOs resulted in a reduction in regulatory asset lives from 33 years to 20 years, whilst ensuring the impact was NPV neutral. We believe that a similar approach of reducing regulatory asset lives to similar levels remains valid for transmission companies. We expect that the forthcoming Ofgem / Ofwat paper will analyse the impact of shortening asset lives as well as alternative ways that have been used to address the financeability issue such as providing for a higher cost of capital.

9.35 – 9.51 The treatment of Pensions

The Occupational Pension Schemes (Scheme Funding) Regulations 2005 and the Pensions Regulator’s Code of Practice: Funding Defined Benefits came into force in December 2005. Both of these substantially changed the environment in which future actuarial valuations of pension schemes will be carried out, and are expected to affect the future pension contributions of employers.

The new legislation and guidance will require trustees to set the assumptions which will drive funding targets and pension contributions. The Pensions Regulator has given guidance that he expects to see funding targets set in the range of 70%-80% of the scheme’s buy-out liabilities. As a result of this guidance, it is possible that trustees will look to adopt stronger funding assumptions, resulting in higher pension contributions.

The Pensions regulator has also given guidance that he would expect to see Trustees looking to repair deficits over periods of not more than 10 years, and potentially less depending on the strength of the employer's covenant. Trustees are required to agree this period with the employer, and if they cannot reach agreement then the Pensions Regulator will become involved.

The changes resulting from the Pensions Act 2004 leave employers facing the likelihood of higher pension contributions, accompanied by a reduction in control over pension costs, since trustees now have greater powers. Price controls should recognise these costs and treat them in accordance with the principles detailed in Appendix 10, paragraphs 10.3 and 10.4, that is that any over or under provision against the allowances are "logged up" and the impact passed through to consumers at the following price control, but any exceptional changes to be reviewed by Ofgem during the price control period.

However the approach to logging up as described in Appendix 10, paragraph 10.13 may be too simplistic. Ofgem should also take into account the investment strategy of the pension scheme. If pension fund trustees have properly adopted a strategy to "de-risk" a pension fund by investing in an increased allocation of bonds then the investment return would be notably different to the median returns of a typical pension fund. It is typical that a scheme which moves investments to a higher bond weighting will experience increased pension costs. This is because the actuary would then normally assume a lower expected average investment return on the assets. It would be inappropriate to penalise companies by reducing allowances if trustees have adopted such a prudent strategy. By a similar argument, increased funding rates may not imply a failure of stewardship.