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Transmission Price Control Review Initial Proposals

Dear Robert

The Initial Proposals paper for the Transmission Price Control invites interested parties to respond to the issues raised. At a time when it is generally recognised that the UK's energy networks require significant investment, Central Networks believe that constructive comment on the proposals is in the best interest of all parties.

We believe that the most critical issue raised in the Initial Proposals is the proposed cost of capital. Against the backdrop of increasing capital expenditure to replace ageing network infrastructure, it is vital that network companies can attract investment. The cost of capital set for transmission companies must allow them to be attractive to equity investors when compared to other UK and international utility sectors.

We have responded to a number of questions raised by the Initial Proposals. 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 Transmission Price Control Review Initial Proposals

7.13 Cost Uncertainty

The licensees in their submissions have identified an upwards pressure on capex resulting from increases in market prices for materials and labour.

Since the last price control, we have also seen a general trend within the electricity distribution sector of increasing market prices for plant, materials and labour.

We believe that this trend is likely to continue, driven by increasing investment across all utility sectors, and other major capital projects such as the Olympic Games, leading to strong competition for the same contractor resources. This increased demand will impact the ability of companies to deliver capital programmes effectively and we welcome the fact that this upwards pressure on capex and opex has been recognised within the TPCR initial proposal.

Ofgem have indicated that it prefers to use ex ante allowances for such factors within the capex and opex allowances, rather than alternatives such as the greater use of input price indices. However, details have not yet been provided.

We believe that it is important for licensees to model these increases within their forecasts and that there is an established regulatory process that reflects these indexation levels realistically in the allowances. Any such methodology for addressing cost uncertainty within the price control needs to be transparent and clear in order to reduce regulatory risk.

We will provide further comments when Ofgem presents its updated views on the level of any such allowances in their September update.

7.14 Specific foreseeable events

In the case of foreseeable events where costs are uncertain then a re-opener is an appropriate response. Where costs are known but volumes are uncertain then a revenue driver as part of the price control is appropriate.

7.15 – 7.24 Treatment of Non Operational Capex

Some non-operational capex projects repeat over a period of time, for example fleet renewal, but other projects are 'one off' and consequently the treatment of these projects as capex or opex should be assessed on a case by case basis.

We note and agree with Ofgem's points in paragraph 7.23 on the need to ensure efficiency of non-operational capex spend. However, mechanisms to ensure capex spend is efficient are embedded into price control reviews – either through a direct challenge of capex proposals or an automatic mechanism such as the DNOs' sliding scale. Non-operational capex is, almost by definition, much "lumpier" than business-as-usual opex and is likely to be correlated with increased operational capital programmes (e.g. vehicles). Remuneration through depreciation payments is therefore in many cases likely to be more reflective of the underlying cost drivers.

Paragraph 7.22 notes that SO IT systems are integral to the SO's core operations. We believe that, since the definitions for non-operational capex were created, increasing amounts of IT systems (control and communications) are becoming integral to the normal operation of the distribution network. This will increase in the future – with the introduction of BT's 21st Century Networks programme, increasing amounts of automation and active network management technologies. A rising amount of operational assets will consist of equipment that would either now be classed as non-operational or have a much shorter lifetime than "traditional" network components.

These are good reasons why it might be more sensible to review the definition of non-operational capex and consider expenditure as "asset related" or "non-asset related", rewarding the former as capex (with appropriate depreciation lifetimes).

7.26 – 7.27 The scope for efficiency savings

We note the 1.5% ongoing efficiency improvement, and the particular observation that detailed analysis of NGET and NGG suggests that this reduction is 'challenging but achievable'. The question remains, however, of how long after privatisation a regulated company can be expected to improve efficiency at a greater pace than the general UK economy which is already encapsulated within the calculation of RPI.

7.30 – 7.36 TPCR Capital expenditure incentives

The interim user commitment arrangements proposed by NGET provide both a signal of the need for network reinforcement and a method of sharing risk between users and the transmission company. We note that no similar arrangements exist in distribution, and given the different scale and characteristics of the investment involved this is reasonable. However, the absence of a mechanism for reducing DNOs' risk in undertaking major reinforcement programmes that may subsequently prove unnecessary is a distinction between electricity transmission and distribution. We would argue this distinction should be reflected in the difference in allowed cost of capital between distribution and transmission.

8.2 - 8.5 Cost of capital

In our covering letter we have emphasised the need for the transmission companies to remain attractive to equity investors particularly given the need to fund an increasing investment programme. The consequences of not doing so are underinvestment and a longer term downturn in network performance and reduced quality of supply for consumers. Existing investors have made a financial commitment to the companies based on an expected return over the lifetime of the asset. If lifetime returns were lower than anticipated at the time of the investment decision as a result of a regulatory decision then the prospect of increased regulatory risk could deter future investment in that sector.

8.17 – 8.19 Financeability

Raising equity

We believe Regulators should not inadvertently deter companies from the equity markets and we welcome the fact that Ofgem have recognised the important role of equity in financing investments. Equity is a strong incentive in driving operational efficiency and rewarding out performance, and debt does not necessarily provide the same efficiency incentive. Any regulatory regime which assumes high gearing in setting an allowed return will drive high gearing and discourage equity.

An important factor that inhibits equity injections is that in general in the UK, regulators have previously not allowed for the transaction costs of raising new equity. These costs can be substantial and may be a reason why there have been very few equity issuances in the UK utility sectors. Furthermore, there are indirect costs associated with rights issues which regulators have not accounted for.

Ofgem have indicated in the TPCR initial proposals that they will need to set the cost of equity appropriately to take account of the marginal cost of equity injections required including transaction costs. This will increase the attractiveness of equity injections, which previously was a potential barrier within the UK utilities sector. However, it is also important that Ofgem sets the cost of capital at a level that is sufficient to make any equity investment attractive.

Reduction of regulatory risk

We believe that improvements have been made in recent years in providing transparency in the regulatory process. We recognise that regulatory risk cannot be fully eliminated, however there is still scope for regulators to reduce risk through:

- i. Ensuring clearer rules for the RAV
- ii. More clearly explaining the rationale behind all decisions made
- iii. More identification up front of any areas that may change, again clearly explaining the rationale

10.3 – 10.16 Revenue Drivers

The proposed two part revenue driver is a proportionate approach to addressing the uncertainty in both magnitude and timing of investment relating to new loads. Both parts of the driver must be robust to ensure there is no question of investment being retrospectively deemed to be 'inefficient'.

10.17 – 10.20 Links to the Scottish Islands

We support the suggestion to open up these projects to competition and agree that this may be effective in both generating information on efficient costs and designs and reducing the final costs of the project. The introduction of competition for these connections is consistent with the approach being taken for connection of offshore renewables which may also benefit from the information on efficient costs and designs from the island connections.

10.21 – 10.26 System performance

We note the proposal to move to a 'penalties only' scheme for transmission networks and recognise the reasoning behind this. However distribution networks retain the scope to improve network performance through investment and so a combined rewards and penalties scheme remains appropriate for distribution companies.

10.27 – 10.29 Innovation incentives

We support the principles behind the introduction of the innovation incentive across transmission having witnessed the success such a scheme has been in stimulating investment in distribution.