

What will be the impact of a shift to a post-tax cost of capital?

Note prepared for the gas DNs

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1 Introduction

In its second consultation paper on the gas distribution price control review,¹ Ofgem announced its intention to switch from a pre-tax to a post-tax approach to regulation. Under the former, tax liabilities are remunerated through a tax wedge applied to the cost of equity, with the tax wedge calculated at the statutory rate. Under the latter system, liabilities are remunerated through an increase to operating costs, taking into account the effective tax rate of each of the gas distribution networks (DNs). This switch—proposed to apply to both the one-year extension as well as to the next main review period—would bring the treatment of the gas DNs into line with that of the other sectors that Ofgem regulates—ie, electricity distribution and transmission companies.

The arguments of *principle* surrounding these two approaches to remunerating tax liabilities are well rehearsed, and apply equally to the gas distribution sector as to the other sectors regulated by Ofgem.

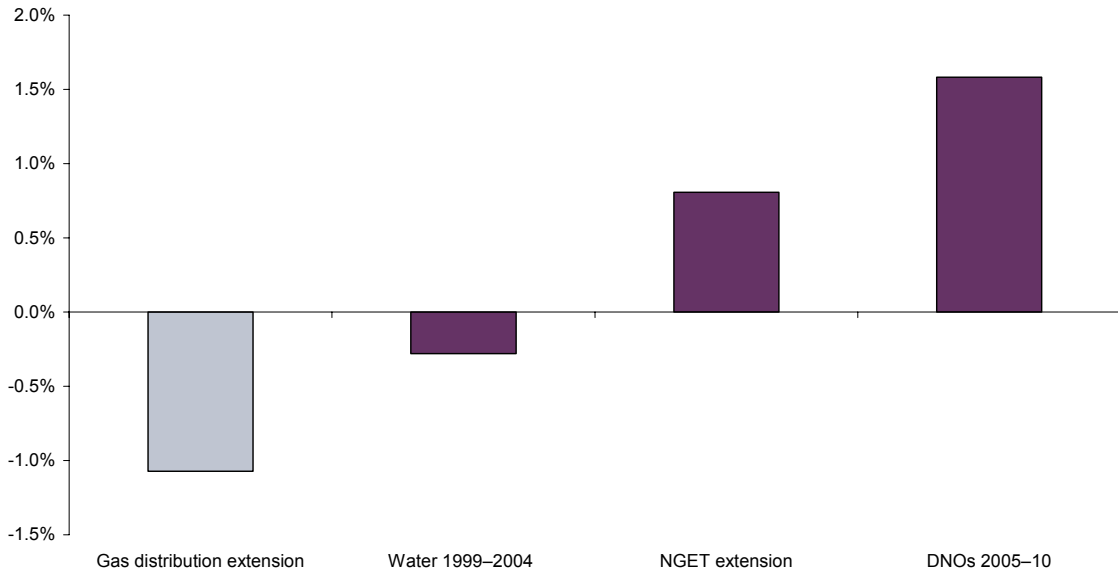
However, there are significant differences in the impact of the *application* of this approach to tax remuneration in the gas distribution sector relative to other sectors. The shift to a post-tax approach to regulation will have a significant negative impact on the revenues of the gas distribution companies. The purpose of this note is to compare the magnitude of this impact in the gas distribution sector with that of the sectors where moving from a pre-tax to post-tax approach to tax remuneration has been undertaken (or proposed). Furthermore, in light of this comparison, this note suggests ways in which Ofgem could mitigate what would otherwise be the substantially negative impact on the net present value of revenues of the gas distribution companies.

¹ Ofgem (2006), 'Gas Distribution Price Control Review: Second Consultation Document', July.

2 Shift from pre- to post-tax cost of capital: regulatory precedents

There have been a number of other sectors where regulators have moved from a pre-tax approach (using a statutory tax rate) to a post-tax approach (using an effective rate). The figure below compares the impact on revenues of this change in regulatory policy for different companies/sectors (as a percentage of regulatory asset value, RAV) in the first regulatory period in which the policy was applied, and compares this with the impact that the gas DNs have calculated for their sector.

Figure 2.1 Impact on revenues of a shift from pre-tax to post-tax regulation



Notes: Gas distribution impact calculated on the basis of a 'typical' DN, effective tax rate in 1999-2004. Water sector calculated at 27%, based on Ofwat City Briefing, May 2001 (see Stones, C. (2001), 'Changes in the Pipeline? Economic and Public Policy Implications of Water Industry Restructuring', July, The Social Market Foundation), and average regulatory capital value (RCV) for all companies over the entire period. NGET: all figures taken from Ofgem (2004), 'Electricity Distribution Price Control Review: Final Proposals', November. Distribution network operators (DNOs): effect calculated as the sum of each DNO in each year, and then averaged over the five years.

It is clear that, relative to the other comparable sectors, the gas distribution sector is something of an outlier, with the net negative impact on annual revenues estimated to be in excess of 1% of the RAV. It is also particularly noteworthy that, while in the other sectors that Ofgem regulates the impact of the policy has been to increase revenues, the policy has the opposite effect for the gas DNs.

3 Potential mitigants

This evidence suggests that the move to a post-tax cost of capital will have a much more significant negative impact on the revenues of the gas distribution companies than for other companies that have experienced the same shift in regulatory policy. Given the recent emphasis on the benefits of regulatory commitment and stability, this is a significant finding and suggests that Ofgem should not apply the move without careful consideration of the financial impact on the gas distribution sector.

There are at least two ways in which Ofgem could continue to adopt a post-tax approach to regulation while also addressing the financial impact observed above.

- Consistent with the arguments that are frequently cited regarding treating the price control as a package, Ofgem would simply need to take a more conservative approach to other aspects of the price control and, in particular, ensure a reasonable post-tax allowed return.
- A slightly more radical approach would be to adopt the post-tax cost of capital only in relation to profits made on RAV additions made from the start of the next price control review, and continue with the pre-tax (statutory) approach in relation to the profits derived from assets that are already within the RAV. This would continue to allow the gas DNs to earn the cash flows on previously invested assets that were expected at the time that those investment decisions were made. As such, it would be more consistent with maintaining regulatory commitment to past investments, while amending forward-looking regulatory policy.