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Dear Robert

Transmission Price Control Review : Updated Proposals

I would like to comment on some aspects of your recent proposals, particularly where the issues discussed have clear parallels with the regulation of other energy networks. I have set out our views under the Chapter headings used in your consultation paper.

Policy and cost assessment issues

Question 7.1: Do you agree with our proposed incentives for efficient capital expenditure, including a 25 per cent incentive rate?

It is important that companies are offered powerful and consistent incentives for cost efficiency. We would expect to see incentives for capex and opex to be of similar strength (to avoid the temptation to convert opex to capex or vice versa). The 25% proposed is therefore on the low side, and would only be appropriate if it can be justified by the levels of uncertainty within the cost projections. We note that it is comparable with the lower end of the sliding scale used in DPCR4 where very significant capex growth had been projected by some companies. As output measures are developed and revenue can be matched more accurately with activity levels, we would expect to see efficiency incentives strengthened in future.

Question 7.2: What do you think about our proposals to address significant capex under spend? In particular:

- (1) What action should we take if this happens?
- (2) At what level should we trigger this response?
- (3) Should this response apply to load related and non load related capex?

We find it surprising that there could be such great uncertainty over the volumes of non-load related capex that a company's actual spend may vary by more than 20% from the forecasts developed within the price control review process. Only in the event of some major disruption (such as the recent Foot and Mouth epidemic) should there be such a significant discrepancy. We would not expect price controls to be designed to cover all possible, but low risk, eventualities. Instead there could be cause to reopen the price control discussions if outturn varied wildly from the original assumptions. With the extending use of annual Regulatory Reporting Packs (RRP), Ofgem should have early visibility of such circumstances. We can see greater prospect of load related expenditure differing from forecast and

therefore we support the introduction of revenue drivers that reflect volumes of work associated with new demand and generation.

Question 7.3: Do you agree with our proposed approach for dealing with uncertain costs including future input price changes, specific cost uncertainties, and wider regulatory developments?

This question needs to be seen alongside your assumptions on the scope for productivity improvement. We are surprised that you believe that transmission companies can reduce operating costs so quickly at a time when service costs are rising much more rapidly than the goods component of RPI. While your specific proposals for dealing with elements of cost uncertainty may have been acceptable within a balanced package of operating cost allowances, they look harsh when considered in parallel with the general assumption on productivity improvement.

Financial issues

Question 8.1: Do you agree with the conclusions of the Smithers & Co cost of capital study, in particular the real cost of debt and equity?

We believe that it is important to maintain regulatory consistency in setting the cost of capital. We are concerned with the conclusion in the Smithers and Co study that setting equity betas equal to one appears generous. The analysis is based on data derived from companies whose scope extends far beyond energy networks, and uses short run market information to determine the key components. The cost of capital assessment needs to be framed in terms of the long run view, taking account of previous regulatory decisions, to maintain investor confidence. We do not believe there is any evidence over the long run to support the conclusion on equity betas in the report.

We are encouraged that you have indicated your intention to take this longer term view on the cost of capital in this and previous price controls, recognising the characteristics of the industry, the importance of equity as a source of funding, and the nature of the assets being funded.

Question 8.2: Do you agree with our proposed revised treatment of pensions costs?

We support the approach to pensions adopted in the update proposals. It is important to maintain consistent treatment of comparable components of the cost base across utility price controls. Pension allowances are an obvious area where consistent principles should be applied and the DPCR4 control has set important precedents in this area.

At some stage it will be important to discuss how the future trade-off between scheme risk and potential returns should be handled, so that companies can understand clearly what is meant by pass-through of future costs. We are aware that this has been a significant topic of discussion between PostComm and the Post Office, and that similar clarity in the energy sector will be helpful to all parties.

Question 8.3: Do you agree with our proposed approach to the provision of new equity?

If gearing levels are to remain stable it will be essential to raise new equity to contribute to the increasing need for investment finance. It is therefore essential that issuance costs are considered within the overall cost of equity. In this context we do not understand why equity issuance costs would

only be allowed on an ex-post basis. Apart from the complexity that would be introduced in such a process it is also inconsistent with the basic principle of incentive regulation. Companies should be encouraged to minimise issuance costs, and therefore be presented with ex ante allowances.

Adjustment mechanisms and incentives

We do not feel able to comment on the detail of your proposals but we welcome the principle of revenue allowances and incentives more accurately tailored to individual company circumstances. We hope that this model will be extended to DNOs in DPCR5.

Question 9.6: Do you agree with our view that an Innovation Funding Incentive is appropriate?

We have found the IFI a highly effective mechanism for encouraging additional expenditure on R&D and would expect it to be similarly beneficial for transmission companies.

Sustainable development and the environment

Question 11.1: Do you agree that the licensees should be incentivised to reduce leakage of SF6? Do you agree the incentive should be set for 5 years?

We support incentives on transmission companies to reduce SF6 emissions as a further contribution to environmental policy. As a first step a single measure based on five years' performance may be appropriate but the valuation of the emissions saved should reflect the longer term benefit. It would be unfortunate if achievable leakage reductions were not implemented because the rewards did not adequately reflect the longer term benefits.

Question 11.2: Do you agree with our proposal not to apply the DPCR approach to transmission undergrounding? Do you have views upon how we may best factor this in to our decision?

Yes, we believe that far greater benefit can be achieved from undergrounding of distribution networks. If more resources are to be applied to environmental benefits of this kind, they should be targeted at lower voltage overhead networks.

I hope that you find these comments helpful. Please do not hesitate to contact me should you wish to discuss any items further.

Yours sincerely

Mike Boxall
Electricity Regulation Director