Electricity Distribution Price Control Review (DPCR5)

Initial Proposals – Allowed Revenues and Financial Issues

Electricity North West Response

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Note on Layout

Our response to the Ofgem Initial Proposals follows the framework set out in the consultation. The document is prefaced with an executive summary.

Answers to Ofgem's specific questions are contained at the end of each chapter.

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1 Executive Summary

Following the global economic crisis, there has been a fundamental shift in the liquidity of the capital markets. Moreover, debt and equity investors now expect greater and more secure yields and returns before investing and these effects are likely to be with us well beyond the next price review period. The allowed return at DPCR5 needs to realistically reflect the new status of the financial markets. The level of return needs to be set at least equal to the long-term view of the weighted average of the costs of debt and equity, adjusted for the impact of recent events and cover the total financing costs required by an efficiently managed DNO. Ofgem's outlined approach to setting the allowed return is out of step with recent regulatory price control decisions and reputable commentators, who have recognised a change in the pricing of risk by the debt and equity markets that needs to be captured in the cost of capital assessment. The recent ENA/Ofgem survey of investors confirms this.

We support many of Ofgem's proposals to mitigate certain increased risks since DPCR4, e.g. tax triggers, but believe that simple and practical mechanisms need to be adopted if these are to gain general acceptance. DPCR5 will introduce new output targets that increase execution risk for DNOs. In addition, the tightening of targets in the Losses and Quality of Supply incentive schemes and the introduction of new incentives related to transmission exit charges and customer satisfaction further increase risk to revenue. The final resolution of the cost of capital debate will need to address the balance of risk taken by investors across DPCR5.

Insufficient cost and revenue allowances can have at least three potential impacts on our business and ultimately our customers:

- damage to our ability to continue to operate effectively within the required financial ratios;
- damage to the levels of service experienced by customers; and,
- damage to our ability to earn the necessary return that will ensure the continued re-investment and attraction of investors to the industry.

While in the short term, we may be able to manage within our existing financial ratios by cutting back on expenditure and not meeting equity return expectations, insufficient allowances will adversely affect the future availability of debt and equity to the sector, which is competing in a global market.

The inadequacy of the cost allowances calculated for the initial proposals would not enable ENW to operate within the financial ratios unless we cut £176m from our asset replacement programme to fund other essential expenditure. We understand that Ofgem intend to revise the cost allowances at the same time as completing the work on the financial model, issuing revised revenue forecasts on 5 October. We will comment further on the financial viability of DPCR5 when we have received these revised forecasts, taking into account Ofgem's working assumptions for WACC and pensions.

Whilst we acknowledge that there has been some progress in developing the financial model for DPCR5, there are several key aspects that still require amendment. In working with the Ofgem team we have identified several material errors in the model used for the initial proposals that have a particularly adverse affect on ENW and whose correction will have a significant impact on the allowed revenues for DPCR5.

Insufficient allowance has been provided for pension costs, particularly deficit funding, where only 45% of ENW's pension scheme deficit has been assumed to be funded over ten years in the initial proposals. This appears to contradict the intent of the words and tables contained in the initial proposals document. Further, we welcome Ofgem's assurances that the 92% regulatory fraction for ENW quoted in the initial proposals is an error that will be corrected to 100%. We will continue to support Ofgem's team in refining its understandably complex, but vitally important, financial model.

We do not believe Ofgem's financability tests adequately reflect investor and rating agency requirements in the current financial climate. We urge Ofgem to discuss this issue with the financial community so that the price control is conducted taking into account the important relationship the DNOs have with the financial markets. The financial model needs to be comprehensively stress tested for changes in key assumptions, e.g. RPI and interest rates, and you should share the approach and conclusions that demonstrate that the price control proposals have adequate headroom to cope with the uncertainty in the key components. Financability would be adversely affected by a change in the revenue profile from one that follows the path of costs to a smoothed profile. Whilst a smooth profile might delay price increases for customers, it would result in five year cycle of a repeating above RPI price increases and additional costs to address the increase in financial risk.

2 Cost of Capital

2.1 Use of WACC

The use of the DPCR4 WACC as a working assumption in the Initial Proposals represents a significant change in regulatory procedure. The justification that the WACC can only be determined after other key mechanisms of the regulatory package are determined reflects a substantial change from Ofgem's and other regulators' previous policies on cost of capital.

The difficulty that arises from a "working assumption" with regard to the WACC is that it makes it more difficult to review and respond to the overall DPCR5 package.

Various statements in the initial proposals document indicate that Ofgem does not propose to set the allowed cost of capital with reference to companies' underlying cost of capital:-

"*We think there should be a trade off between the cost of capital we use and the scope the settlement provides for shareholders to earn more through outperformance on incentive schemes."(Ofgem, Initial Proposals, overall document 92/09, page 1 para 4)*

"*We do not consider it is appropriate to deliver a price control settlement that both allows the DNOs a relatively generous cost of capital and where the control is calibrated to provide the DNOs with more upsides than downsides." (Ofgem, Initial Proposals, overall document 92/09, page 42 para 4.7)*

The above comments suggest that Ofgem proposes to use the WACC as an allowance needed to top-up revenues to compensate for areas of the price control where it has set allowed costs below companies' actual or expected costs over DPCR5. We consider that this approach to the determination of its WACC to be incorrect. The WACC is a real cost that has to be recovered. The level of this cost is defined (in theory) as a function of investors' exposure to risk, and is therefore a function of the revenue risks imposed under the regulatory framework and exposure of DNOs cost risks. The cost does not depend on the level of Ofgem's allowances in other parts of the price control.

2.2 Current Market Conditions

The recent turmoil in financial markets has implications for DPCR5 and the WACC. A key issue for setting the WACC at DPCR5 is how much weight to place on current market conditions versus long-run historic data. The two questions that will drive the appropriate weighting are:

- How long will current conditions persist for, i.e. how long will the recovery take?

- What capital market conditions will prevail following the recovery?

Work carried out by NERA on behalf of DNOs through the Energy Network Association provides a range of evidence on answers to the above two questions. The detailed analysis is contained in section 7 pages 34 to 38 of the associated document "NERA

report on the Cost of Capital for DPCR5", distributed as part of the initial proposals documentation.

In summary the analysis provided by NERA suggests that the economic outlook and expectations of post recovery conditions shows that independent forecasters like the Bank of England, OECD and IMF do not expect economic growth and inflation to return to trend rates until 2012 or 2013, half-way through DPCR5. In addition, given that there is greater-than-normal uncertainty surrounding economic forecasts greater weight needs to be given to the possibility that economic conditions will not "normalise" until even later. Further, since market commentators do not expect financial conditions to return to pre-crisis conditions, but rather expect that a "new normal" will emerge more weight should be placed on the current cost of capital over and above the long-run historic averages.

2.3 Risks and the WACC

Change in investor perceptions of risk now and at DPCR4

There is strong evidence that risks at the DPCR5 price control have increased since DPCR4.

Work has been undertaken by Oxera on behalf of ENW to determine the change in risks since the DPCR4 price control was determined.

The focus of the work is on how investor's perceptions of tail risk might have increased in the period leading up to the DPCR5 period, relative to the period leading up to the DPCR4 final proposals. A copy of the Oxera report (Tail risk and its mitigation for DPCR5) is attached as appendix 1.

In section 2 of the report Oxera state:-

"Investors take into account the regulatory framework for setting allowed revenue when evaluating investment prospects. Ofgem sets DNOs' allowed revenue so as to allow an efficient DNO to recover a real rate of return on the regulated asset base (RAB), which is itself indexed to the RPI. Investors in DNOs are therefore confronted with two risks that are especially relevant in the present context.

– The DNO bears the risk that the assumed cost of capital may be below its actual cost of capital.

– The DNO bears the risk of differences between variation in input prices (e.g., construction prices) and variation in the RPI."

Oxera conclude that based on evidence with regard to capital market risks (contained in section 2.1 of the Oxera report) and price volatility (contained in section 2.2 of the Oxera report) investors are now faced with risks that are much more likely to make them sensitive to the possibility of low probability, high impact events relative to the period leading up to the publication of the DPCR4 final proposals.

WACC and the Interaction with risk mitigating mechanisms

In the initial proposals Ofgem consider the use of triggers and re-opener mechanisms. In setting the overall WACC at Final proposals stage, Ofgem will consider the extent to which these mechanisms reduce risk. Ofgem are minded to take the effect of this

de-risking into account when setting the WACC. However, ENW are concerned that Ofgem do not assess the actual impact on WACC, but simply use these mechanisms as a starting point for negotiation on WACC, with little regard for actual return tradeoffs.

The trigger and re-opener mechanisms to be used by Ofgem have not as yet been clearly set out as to how they will work in practice. There is also a question as to which mechanisms will be applied in the Final Proposals. Without a clear understanding of how these schemes will work, investors are unlikely to be convinced that these mechanisms mitigate risks.

Ofgem specifically state that the tax trigger would reduce risk and should be reflected in the WACC:

"*DNOs acknowledge that de-risking them from uncontrollable material legislative changes should also be reflected in the cost of capital" Ofgem, Initial proposals DPCR5 – Allowed Revenues and Financial Issues. Para 4.16.*

Although this mechanism can reduce the variance in the allowance, ENW do not believe this is a WACC issue. Changes in tax legislation (i.e. changes in corporate tax rates, re-classification of capital allowances, etc.) are not correlated to economy-wide events. Furthermore, it is our understanding that the mechanism works symmetrically and hence does not expose DNOs to asymmetric risk. This type of mechanism might align more closely companies' risk preferences with projected outcomes, but should not have an impact on the overall WACC. In addition, uncertainty in the area of tax has increased substantially since DPCR4, indicating that the introduction of a tax trigger is merely mitigating a higher level of tax risk.

A further area that Ofgem are proposing to use the WACC to "bargain" over allowances it has not yet decided upon is contained in the pensions consultation document. Ofgem argue that the maintenance of the status quo with regard to the treatment of pension costs arguably means that DNOs face less risk than other regulated utilities. Ofgem are therefore minded to take this into account in setting the cost of capital in price controls.

Work carried out by Oxera on behalf of ENW has looked at why the status quo on pensions should not, by itself, imply a lower cost of capital for DPCR5. A copy of the Oxera report (Pensions, DPCR5 and DNOs' cost of capital) is attached as appendix 2.

The conclusions that Oxera draw out from their analysis are that although it may be true that, other things being equal, the current pensions regulatory regime for DNOs suggests that these companies face less risk overall than if the regime were amended to leave greater exposure to pension costs with companies, this would not seem to have obvious implications for what the assumed cost of capital for DNOs should be. In particular:-

- it does not mean that the cost should be less than DPCR4 – because the existing pension regime was introduced at DPCR4;
- it does not mean that the assumed cost of capital for DNOs should be less than that of other regulated utilities and, in particular, it does not mean that it should be less than that of the large water and sewerage companies, which are an obvious comparator.

2.4 Methodology and indicative range

The current Ofgem view is to maintain the approach of placing more emphasis on the long run "time series" approach to the overall cost of capital and that current market evidence should be disregarded except insofar as it is updated into long-term historic averages.

We disagree with this approach as this assumes that conditions over DPCR5 will resemble the long-term averages more closely than current conditions. The only methodology that is relevant in the current economic climate is to estimate the impact of current market conditions on the WACC, and exercise judgement in weighting this with the long-term historic WACC to arrive at a single overall WACC for DPCR5.

We note the comments with regard to the use of debt triggers or a reopener to manage the volatility of the cost of debt in view of recent market turmoil and provide our view in the cost of debt trigger/reopener section below.

In conjunction with NERA we have reviewed the PwC report commissioned to assist and inform Ofgem of the appropriate cost of capital for DPCR5. Comments and observations on each of the elements of the methodology contained in the Initial Proposals are provided in the sections below where applicable:-

2.5 Cost of Equity

PwC advocate the use of CAPM as the principle methodology for calculating the cost of equity. The use of the DGM is largely ignored by PwC on the basis that the model requires accurate dividend growth forecasts and it produces highly volatile estimates of the cost of equity because it is affected by share price movements.

The arguments against the use of the DGM are rebutted below.

(i) *"The model requires accurate dividend growth forecasts"*

This statement is incorrect. Instead, share prices reflect investors' expectations of future dividend growth. It does not matter whether these expectations are accurate or not. A variety of data sources are available to help gauge what investors might reasonably assume about dividend growth rates for utilities such as analysts forecasts, historical growth rates, and company projections of dividend growth set out in company business plans. Even if it is only possible to put a plausible range around investor expectations, the DGM still provides an important cross check on the CAPM numbers.

(ii) *"It produces highly volatile estimates of the cost of equity because it is affected by share price movements"*

The DGM cost of equity does not necessarily change as share prices change. Share prices can adjust to revisions in dividends and earnings projections as well as changes in market discount rates. Changes in share prices per se are not a reason to dismiss the DGM. The CAPM also relies on share price data and beta changes as the share price changes. Changes in market data over time reflect efficient and liquid markets and do not invalidate the use of either the DGM or the CAPM.

The use of CAPM by PwC in isolation by disregarding all other market evidence in the determination of cost of equity is fundamentally flawed. The fact that the CAPM can

produce a wide range of results makes it necessary to cross check the outputs from this model with other market data. The arguments set out above defending the use of the DGM would indicate to us that the use of this output as a cross check against the CAPM must be adopted in the overall determination of the cost of equity. Work undertaken by NERA in calculating the current cost of equity produced a range of 7.3% to 10.5% based on the CAPM approach and 8.0% to 10.6% using the DGM. Combining the two approaches NERA have concluded on a current cost of equity in the range 8.0% to 10.5%.

2.6 Risk free rate (RFR)

The observations with regard to the use of Index Linked Gilts to measure the RFR and the distorting effect of UK pension funds make it important that cross checks are built in to the determination of the range. ENW would agree that both the swap rate and nominal gilt approaches to determining the RFR should be factored into the cross check process. In discussing the swap-based methodology to estimate the RFR, PwC appear to overlook the fact that there is strong academic support for using swaps to estimate the real RFR.

2.7 Equity Risk Premium (ERP)

The PwC methodology in estimating the ERP is predominantly based on long term historical averages of equity market returns. An implicit assumption of using long-term historic data is that past expectations are an unbiased estimate for future expectations. This assumption, however, is questionable at the current time of heightened market uncertainties. There is a wide range of evidence that shows the ERP is higher than long run historical averages. This includes:

- forward-looking evidence from DGM models that shows ERP increasing consistent with declining share prices and increased perceptions of risk;
- data on implied market volatility from call options on the FTSE 100 index that shows investor expectations of risk have increased and are forecast to stay at an elevated level relative to recent history for at least the next 18 months;
- evidence from the debt markets: movements in spreads on corporate bonds adjusted for the premium for the expected loss rate suggest that the ERP has increased sharply in recent months;
- evidence from the Bank of England and other central banks that show central estimate of the ERP have increased in recent times;
- evidence of higher ERP assumptions by major investment banks; and
- evidence of higher ERP assumptions by other regulators such as Ofcom.

ENW therefore believe that there is a necessity to give more weight to current market evidence in setting the overall range for the ERP.

2.8 Beta Estimates

PwC have assumed a debt beta range of 0 to 0.1 in order to reflect the recent Competition Commission approach. The Competition Commission estimate of a 0.1 debt beta for BAA's London airports, based on a BBB rating, suggests that a debt beta for

the DNOs (on an assumed A – rating) would be lower, since a higher credit rating corresponds to a lower systematic risk. We have therefore seen no evidence to suggest the debt beta should be other than zero.

2.9 Overall cost of equity

The overall PwC range of 4.0% - 8.5% for the cost of equity is extremely wide. The absence of cross checks against other market evidence (e.g. DGM, premiums on transaction evidence) and the simple combining of plausible ranges for each of the CAPM parameters, with little regard for internal consistency of the overall CAPM results, contributes to this wide range. The lower end of the cost of equity range presented by PwC is particularly concerning and, as observed by Ofgem, would result in a figure that is much lower than any recent, comparable regulatory settlements.

The NERA approach to the cost of equity is to look at both the historic cost of equity based on the CAPM model and to also look at a current estimate of the cost of equity that combines both the CAPM and DGM approaches. The NERA range for the historic cost of equity is 7.2% to 8.6% and for the current estimate the range is 8.0% to 10.5%.

2.10 Debt Spreads

PwC focus on the long term 10 year average premia methodology in determining the debt spread to be used in the overall WACC. An alternative approach would be to estimate the cost of debt by reference to the fact that DNOs have raised debt in the past at more favourable rates than currently observed and that companies face higher debt costs in financing capex over DPCR5 than in the past. The cost of debt allowed could be calculated by the weighting of the long-term time series evidence on the cost of debt for the proportion of debt the sector will not be refinancing over DPCR5 and current evidence on the cost of debt for the proportion of new debt (i.e. refinancing of existing debt and new debt to finance new capex over DPCR5).

It is also noted from the PwC report that they believe DNOs should be compensated for transaction costs. Transaction costs have increased in recent years and we support this conclusion and to illustrate this we provide two examples below. However, PwC believe that any compensation should not be made through the adding of an up-lift to the cost of debt but via an explicitly modelled allowed cash flow. Further clarification on how this would operate should Ofgem adopt this approach would be welcomed.

Two examples of increased Transactions costs relate to the cost of liquidity that any DNO needs to prudently maintain in order to ensure availability of funds to meet committed capital projects against uncertainties around the availability of new long-term debt. The experience of the last 18 months, during which the debt capital markets were essentially closed on any reasonable basis for a period of 3-4 months from September 2008 to January 2009 highlights the need for DNO's to maintain liquidity in the form of cash or committed bank facilities.

As an example ENW has recently arranged a new 3-year committed bank facility from a group of 3 leading UK banks. The drawn margin price is 2.25% over Libor but the key point is the ongoing commitment fee on an un-drawn basis is 0.90%. Also the upfront arrangement fee is 1% of the facility amount.

These fees compare with those on a similar facility arranged in June 2005 of a drawn margin of 0.20% over Libor, an un-drawn commitment fee of 0.09% (9 basis points) and no upfront arrangement fee.

Therefore the costs of holding the facility as committed liquidity (even assuming no actual utilisation) have increased very significantly from 0.09%pa to an upfront fee of 1% and annual fees of 0.9%. An overall increase from 0.27% to 3.7% of the facility amount over 3-years, a figure of 3.43%. The facility in question is for £75m giving an increased cash cost of £2.57m.

The second example is the increased cost of holding cash by way of pre-funding. Clearly with bank base rates at all time lows of 0.5% commercial deposit rates are similarly depressed at no more than 0.8% even for a fixture of up to 6 months maturity. However the long-term borrowing all in rate for an A/BBB+ utility is still around 6.5%-7% reflecting the wider credit spreads but currently off-set by historically low gilt yields. The cost of carry is then currently around 5%.

Prior to the dramatic interest cuts, and generally through the earlier part of DPCR4, with Libor around 5.5% the cost of carry was around 1-1.5% for an A/BBB+ rated entity.

2.11 Gearing

It is noted that you consider a notional gearing level of 55 to 65% remains consistent with a rating that is comfortably within investment grade and that PwC also use this assumption. The NERA cost of capital work undertaken on behalf of the DNOs uses an assumption of gearing of 60%, which we endorse.

2.12 PwC's Proposed WACC range

PwC's overall vanilla WACC range of 3.5% to 5.6% is unsatisfactory for a number of reasons.

- The range is too wide, with the ERP and beta ranges being particularly wide. A much narrower range is necessary in order to be useful for setting prices at DPCR5. This could be achieved by justifying a clear methodology for estimating individual WACC parameters; cross checking CAPM ranges against other market evidence and checking that the WACC is broadly consistent with regulatory precedent.

- PwC's WACC analysis appears to take no account of the recession and credit crisis. PwC only use historic evidence (over 5 or 10 years) to estimate the cost of capital for DPCR5. This approach implicitly assumes an immediate return at the start of DPCR5 to the favourable market conditions over the historic period. This view is out of line with the broad consensus of opinion which says that there has been a fundamental re-pricing of risk, particularly in debt markets. Experience of past deep recessions also points to a more pessimistic view of the pace of recovery.

- The overall WACC range must pass a test of plausibility. In practice, this means it must be broadly consistent with previous regulatory decisions across a range of sectors keeping in mind the economic circumstances under which the decision was taken.

While encompassing Ofgem's final decision at DPCR4 the overall PwC WACC post-tax WACC range of 3.0-4.85% offers substantially more variation to the downside than the upside of the DPCR4 figure of 4.8%. Given the extraordinary turmoil in financial markets since mid-2007, it does not seem plausible that the WACC for DPCR5 should be significantly lower than the WACC for DPCR4.

Even assuming that PwC is correct in assuming that capital market conditions will quickly return to early DPCR4 levels, the lower end of the PwC post-tax WACC range of 3.0-4.85% is implausible. Simple cross checks illustrate this: Market to Asset Ratios for listed network companies would have been well above 1.0 if the true post-tax WACC was close to 3.0% when regulators have previously allowed regulatory returns of close to 5%.

2.13 Cost of Debt trigger/reopener

We believe the use of debt indexation and/or indexed based debt triggers is not appropriate at DPCR5 because the DNOs are best placed to manage interest rate risk. It would not be in the interests of customers to shift this risk to customers, since this is likely to provide an incentive on the DNOs to be more risk adverse and encourage inefficient debt structures, thereby increasing the cost of debt. Indeed, we note that Ofwat have recently ruled out the use of index-linked debt in cost of capital calculations for UK water companies for new debt. Implementing such a scheme would also create an additional regulatory burden, involve undue intrusion in the financing structure of the DNOs and would need to overcome practical difficulties in determining what type of debt to include in any index. The CC firmly dismissed the use of debt indexation in the recent BAA review referral.

2.14 Chapter Questions

Q1: Do you think that PWC have identified the appropriate range for setting the cost of capital?

A1: See PwC's proposed WACC range section 2.12 for our response

Q2: How should we balance our standard long-term view of the cost of capital with current indicators in the capital markets?

A2: The recent turmoil in financial markets has implication for DPCR5 and the WACC. A key issue for setting the WACC at DPCR5 is how much weight to place on current market conditions versus long-run historic data. The two questions that will drive the appropriate weighting are:

- *How long will current conditions persist for i.e. how long will the recovery take?*
- *What capital market conditions will prevail following the recovery?*

Work carried out by NERA on behalf of DNOs through the Energy Network Association provides a range of evidence on answers to the above two questions. The detailed analysis is contained in section 7 pages 34 to 38 of the associated document "NERA report on the Cost of Capital for DPCR5", distributed as part of the Initial Proposals documentation.

In summary the analysis provided by NERA suggests that the economic outlook and expectations of post recovery conditions shows that independent forecasters like the Bank of England, OECD and IMF do not expect economic growth and inflation to return to trend rates until 2012 or 2013, half-way through DPCR5. In addition, given that there is greater-than-normal uncertainty surrounding economic forecasts greater weight needs to be given to the possibility that economic conditions will not "normalise" until even later. Further, since market commentators do not expect financial conditions to return to pre-crisis conditions, but rather expect that a "new normal" will emerge more weight should be placed on the current cost of capital over and above the long-run historic averages.

The current Ofgem view is to maintain the approach of placing more emphasis on the long run "time series" approach to the overall cost of capital and that current market evidence should be disregarded except insofar as it is updated into long-term historic averages.

We disagree with this approach as this assumes that conditions over DPCR5 will resemble the long-term averages more closely than current conditions. The methodology that ENW would recommend is to estimate the impact of current market conditions on the WACC, and exercise judgement in weighting this with the long-term historic WACC to arrive at a single overall WACC for DPCR5.

Q3: Which, if any, of the alternative methods of dealing with variability in the cost of debt should we adopt?

A3: See cost of debt trigger/reopener section 2.13 for our response..

Q4: What are the pros and cons of the mechanistic debt trigger as suggested by PWC?

A4: Pros

In principle, the mechanistic debt trigger approach could be expected to lower the likelihood that the DNOs would run into financial difficulties as a result of large cost of debt fluctuations.

Potentially the need to provide "headroom" into the initial cost of debt determination is removed which is likely to be of benefit to customers.

Transparency is improved from the perspective of knowing when the regulator is likely to intervene to correct a cost of debt issue.

Cons

Practical implementation and ongoing monitoring of any debt trigger mechanism is likely to be complex and challenging and would require a number of almost arbitrary design decisions to be made by the regulator.

The mechanism is focused specifically on the cost of debt; therefore a review may be initiated even if the DNOs' financeability is not actually threatened.

Introduction of the cost of debt mechanism may be considered a departure from a core principle of RPI-X regulation; setting a price allowance at an aggregate level which is only rarely re-opened.

3 Regulatory Asset Values

3.1 Approach to Methodology and Timing of the Recovery of Expenditure

We support the underlying principles of equalising incentives across the cost base of the DNOs and recognise that this entails the use of fixed RAV additions.

We do not believe that the existing approach of RAV adjustment for increasing excluded services activity is warranted and does not operate in the best interests of customers or the DNOs. We have previously proposed an incentive mechanism to increase activities in these areas for the benefit of DUoS customers and are disappointed that this mechanism has not been adopted (see Chapter 3 for more details).

3.2 Regulatory Depreciation and Asset Lives

We support the continuation of the 20 year depreciation life assumption for DPCR5. The change to a 20 year life when DNOs reached the depreciation cliff face was necessary to meet severe financeability difficulties and the effect will still be felt in DPCR5. Any review of this assumption needs to be made in a longer term context, since there is relevance beyond DPCR5. Changing this assumption impacts on funding, with implications for capital maintenance allowances and the possible use of current cost accounting to determine depreciation allowances that fits better with the RPI-X+20 project.

Continuing with the 20 year assumption for DPCR5 is a pragmatic approach that is fair and consistent across DNOs, some who have already experienced the depreciation cliff face and others where the cliff face occurs in DPCR5.

3.3 Pension Cost Allocations

We believe Ofgem should provide full funding of pension costs, both normal and deficit, at the price control. We note that Ofgem are proposing to allow all deficit funding as fast money in the DCPR5 price control. We agree that this approach follows the sound accounting principles underpinning deficit recovery.

3.4 Related Party Margins

We welcome the clarification by Ofgem on the treatment of related party margins.

We have provided information to Ofgem that demonstrates that the ENW principle service provider margins meet the criteria set out in para 2.13 of the initial proposals.

3.5 Connections

We are comfortable with the treatment of sole use connections as outside the distribution business price control.

3.6 RAV Rolled Forward to 2010

There are a number of outstanding RAV issues that need to be resolved as follows.

- The treatment of ESQCR costs in rolling the RAV forward.

- The adjustment required for the change in regulatory fraction applied to pension deficit costs following the sale of UUE and restructuring of the pension scheme.

- Whether total pension costs in DPCR4 (including pension admin and PPF levy) have been correctly rolled forward in the RAV.

- The correct treatment of some related party margins following the move to a competitive connections market.

We are hoping that further discussions with Ofgem can clarify the RAV roll forward position as soon as possible and we can be confident that a transparent and consistent approach is being applied.

3.7 Chapter Questions

Q1: Do you agree with the draft rules for computing RAV additions and will they reduce or eliminate boundary issues at DPCR5. If not how should they be amended?

A1: We agree that a consequence of equalisation of incentives is the adoption of fixed RAV percentages. The question is how these are best introduced. It is likely that the new approach for DPCR5 will remove many of the boundary issues evident in the past but could potentially create others. This will still require careful monitoring by Ofgem. Care needs to be taken in terms of how sales proceeds are deducted from the RAV to ensure these follow the costs and IQI treatment.

Q2: In what circumstances would you consider it appropriate to have DNO-specific RAV addition percentages?

A2: We believe that it is consistent with the other price control building blocks to apply a common fixed RAV addition for all DNOs and therefore this approach should be adopted by Ofgem.

4 Excluded Services

4.1 Overview

We are extremely disappointed that Ofgem have missed an opportunity to promote excluded services more strongly for the benefit of customers, and have in our view proposed a framework that is far less favourable than the one in existence for DPCR4. The setting of allowances and the proposed treatment of revenues in excess of forecasts are not actions likely to encourage growth in these income streams and will not drive efficient behaviour.

The DPCR4 approach has helped to deliver a 37% increase in the total amount of excluded services forecasts to be deducted from the main price control. This represents a benefit of £65m (2007/08 prices) to DUoS customers over the course of DPCR5. It is unfortunately very hard to imagine that the DPCR5 excluded services proposal will deliver anything like the above, and potentially will contribute to a decline in overall excluded service revenues.

4.2 Proposed Changes

It is evident from further information provided by Ofgem that line 23 of Table 6.3 has been overstated, either the three categories of EHV premises connected post 2005, provision of charging statements and reactive power charging have not been removed, or revenues have not been correctly deflated to 2007/08 prices. It also appears evident that direct revenue protection costs were not included in our latest main table FBPQ submission; consequently DUoS price controlled revenue for DPCR5 will have been understated. Based on our June FBPQ submission this should be £28.2m, not £38.1m.

4.3 Possible Incentive Mechanism

As indicated in our responses to both the Initial Consultation Document and the Methodology and Initial Results Paper we continue to support an all-DNO averaging approach to the forecasting of relevant excluded services. This approach would provide the strongest incentive for DNO's to maximise excluded service revenues, benefiting future DUoS customers and encouraging a more efficient use of the network. The advantage of this approach is that those DNO's with above average activity levels would be incentivised to maintain these levels and those with below average activity levels would be encouraged to increase activity to generate more revenue. Ofgem's current proposals fail the above on two counts, firstly they discourage high achieving DNO's for maintaining or increasing current activity levels and secondly they provide no encouragement to low revenue companies to increase activity. It is extremely unlikely that future DUoS customers in subsequent price controls will see any benefit in this area.

4.4 Chapter Questions

Q1: Do you agree with our proposal to bring the distribution of units to new EHV premises, provision of charging statements and reactive energy transportation within the scope of the main charge restriction conditions?

A1: We support the proposal to bring the distribution of units to new EHV premises and the provision of charging statements within the scope of the main price control. We

identified within our FBPQ, two EHV sites that are currently under development, which will be energised during DPCR5. However there may be others that are as yet unidentified, especially for the later years of the price control. We would expect these to be allowed for via the reopener you propose.

With regard to reactive power, moving this into the main price control will lessen the incentive on DNO's to send charging signals to those customers with poor power factors, as there are no specific performance benefits within the main price control. This proposal therefore is contradictory to Ofgem's objective to reduce network losses.

Q2: Do you agree that revenue protection services should be exempt from a RAV adjustment where reported revenues exceed forecast revenues and that the definition should make clear that the service only includes work commissioned by a third party?

A2: We support the proposal that revenue protection income should be exempt from a RAV adjustment, where performance exceeds forecast revenue. However all works commissioned should be included. Theft leads can come from many sources, not just from suppliers and it would be sub optimal to exclude particular routes to detecting and dealing with theft. ENW are proactive in generating their own leads and suppliers do readily pay and value these additional services.

Q3: Do you agree with the proposed RAV adjustments for top up and standby, other system charges and metered excluded services where reported revenue (costs in the case of metering) exceeds forecasts?

A3: We support the proposal that there is a RAV adjustment where reported revenues exceed forecasts. However the proposal is less generous than the DPCR4 treatment and so will not encourage DNOs from increasing performance, which will benefit customers in DPCR6. We therefore advocate that the DPCR4 treatment is retained.

Q4: Do you agree with our proposals with regard to diversion work in DPCR5?

A4: We do not support Ofgem's proposal in this area. It is wrong to think in terms of margins earned on diversion work. Charges made on a job specific basis include an element for recovery of the fixed overhead for the activities that are necessary to support the diversion processes. The recovery of this overhead can be favourable or adverse depending on the level of activity budgeted for, and the eventual actual performance. It is a particularly difficult task to forecast, as jobs are customer driven, and can be heavily influenced by a few large projects. In addition, historic volumes are not a reliable indication of future workload. Therefore diversion performance can be favourable or adverse in any year, and Ofgem's proposal does not deal with those adverse performing years.

Q5: Do you agree with our proposals regarding metering excluded services?

A5: Revenue arising from metering excluded services is now very small, our FBPQ submission predicted at less than £1m pa. It seems to us unnecessary and extra burdensome to collect costs for these activities. We would propose that revenues continue to act as a proxy for costs.

5 Corporation Tax Allowances

We agree with the current approach adopted to model the tax allowance and agree with the majority of the specific points covered by the initial proposals document. We acknowledge the efforts that have gone into arriving at a tax calculation that is more in line with the way that DNOs calculate tax and in particular the work in the area of allocating expenditure to capital allowance pools on a DNO average basis.

As noted in the main body of the response below, there are a few areas where we have issues.

5.1 Opening Capital Allowance Pools

The FBPQ submission in July 2009 reflects the revised capital allowance balances as per the latest submitted tax computations. Using these balances is consistent with the move toward a tax calculation that is more in line with how DNOs calculate their own tax liabilities. We note however that the current opening tax written down values in the model do not agree to the latest FBPQ submission and we look forward to the balances being brought in line with the FBPQ or an explanation of why they are different.

We recognise Ofgem's desire to start with the correct position for DPCR5 and agree that this is the only proper way for the DPCR5 tax allowance to be a fair reflection of DNO's calculations for DPCR5.

5.2 Modelling of Capital Allowances

We welcome the common approach which relies on an 'average' actual allocation based on reported DNO data, as it follows a consistent approach of applying the same treatment to each element of costs making up the overall revenue allowance.

We accept that whilst the ideal would be to have an un-moderated approach, we recognise that there will on occasion be an outlier that is so different to the other DNOs that to include it would have produced a skewed averaging.

We also accept the practicality issues of having to condense the percentages in Table F8 in the FPBQ into the 8 percentages shown in the Initial proposals and welcome Ofgem sharing the calculations as to how this has been done.

We note that Ofgem acknowledge that the easements have been incorrectly treated in the initial proposals. Easements should be 100% non qualifying but have been treated as 100% revenue spend in the initial proposals document and in the model.

5.3 Capitalised Pension Costs

We do not agree with the inference that different tax treatments arise from DNOs managing their businesses less effectively. There may be circumstances where a DNO has structured their business to produce efficiencies in certain areas but could be penalised due a significantly different tax treatment on pension contributions.

5.4 Tax trigger

We agree with the principle of a tax trigger but do not accept that it materially reduces risks associated with the cost of capital.

We note the proposal for a tax trigger set at 0.5% of price control revenue and that the whole amount and not just the excess over the trigger will be adjusted for. This would equate to a trigger event for us somewhere between an equivalent change in corporation tax rate of between 1% and 2%. We agree with the proposal to adjust for the whole amount but think the trigger value is too high.

It would seem to us that providing the trigger mechanism satisfied certain criteria (similar to those outlined in the initial proposals section 4.13), then any event that falls within such criteria should be capable of being a trigger mechanism. To this end, we would suggest that the wording of the criteria is widened to allow not just tax legislation changes but accounting and tax practice changes.

In particular, Ofgem will have noted the industry's particular concerns relating to IFRIC 18. The effect of IFRIC 18 is not yet known but there is a significant risk that DNOs will have to credit customer contributions to the P+L as they are received and not spread them to the P+L over the life of the assets to which they relate. A fundamental feature of the UK tax legislation is that the accounting profits form the starting point for the taxable profits and a change in generally accepted accounting practice (GAAP) can have a profound effect on taxable profits in much the same way as tax legislation changes. We would therefore argue that the wording for the criteria should be flexed to include, as a potential tax trigger, events such as IFRIC 18 coming into force.

It will still be the case that DNOs will be at risk from changes in case law, tax practice and indeed non mandatory accounting changes that do not meet the criteria set out in the tax trigger

We also consider that in the current economic climate and in these times of unprecedented risk and uncertainty, tax risks are greater than ever before. We believe a trigger mechanism is a necessary requirement to maintain investors' views of and customer confidence in the current risk profile of DNOs.

Any reduction in cost of capital would be a permanent reduction to the financing of business, whereas the tax trigger is only a possibility that could occur. That possibility could work either in favour of DNOs or in favour of customers. The expected net sum cost/benefit is therefore nil.

We do not acknowledge that there is a material impact on the cost of capital as a result of the proposed tax trigger.

We would welcome a worked example from Ofgem on how the tax trigger will operate. This ought ideally to be prior to or at the date of the final proposals so that DNOs can go into DPCR5 with full transparency as to how the mechanism will work, unlike the uncertain nature of the tax claw back, where only now do DNOs understand how that mechanism is to work for DPCR4.

5.5 Capitalised indirect costs

We welcome the use of DNOs own capitalisation policies to allocate indirect costs and recognise the time and effort that has gone into building a tax model that fairly reflects the way DNOs calculate their own tax liabilities.

5.6 Treatment of excluded services

Whilst we believe it would incentivise DNOs more if tax were funded on excluded services and incentives, we accept that Ofgem does not want to fund the tax charge on non regulated activities.

We believe that there should be a consistent approach to the tax treatment of all incentive drivers. It was our understanding that excluded services and incentive mechanisms were also on a pre tax basis on DPRC4 (even if there were certain activities that may have had a tax allowance due to lack of transparency in DPCR4). It is therefore correct and we agree with Ofgem's current approach that any adjustments in DPCR5 relating to amounts from DPCR4 should be on a pre tax basis as this was our understanding in DPCR4.

5.7 Tax allowances in DPCR5

We note the comments that the tax allowance will be based on the actual cash outflows of DNOs and not the P+L tax charge. We still consider that basing the allowance on P+L tax would be a simpler and more transparent method as it would align P+L with cash flow. Furthermore we would not expect the difference to be material. A P+L basis has the added benefit of not having to consider the final forecast year of DPCR4 and provides greater transparency when looking at DPCR5 figures on their own.

5.8 Tax claw back for excess gearing

We note the Ofgem paper dated 31 July 2009 regarding tax claw back. As Ofgem were not prepared to release the calculations for the tax claw back, we look forward to the proposal to build the calculation into the RRP process as this will provide greater transparency in the methodology of the claw back.

5.9 Chapter Questions

Q1: Do you agree with our position on the tax methodology?

See summary response above.

Q2: Do you agree with the proposal to establish a tax trigger mechanism and that we have established an appropriate balance between incentivising DNOs to manage their tax risks and sharing the risks and rewards with consumers?

See tax trigger section 5.4 for our response.

6 Pension Costs

We note that a separate pension consultation has been issued to which a response is being prepared. The comments below are on the content of the initial proposals. No specific questions were raised by Ofgem.

6.1 Normal ongoing pension service

The calculations that have been provided by Ofgem to support the figures for ongoing contributions in the initial proposals appear to have been incorrectly deflated back to 2007/08 prices for a second time as the starting point was the FBPQ submission which was already completed in 2007/08 prices as requested.

The document states that the allowances have been scaled back by an efficiency adjustment of 85.8%, being the same percentage applied to the forecast for network investment and network operating costs. Our views on the efficiency adjustment are discussed elsewhere in the response however; we do not believe the adjustment should be applied to pension costs. The efficiency calculations are performed excluding pensions and a large proportion of the remaining costs are not payroll costs, being consultancy, contractor, IT costs etc. It is not reasonable to assume that if the efficiency of network investment and operating costs is achieved that there will be a like for like saving on pensions. The majority of our pension costs are defined benefit costs for existing employees and therefore cost savings achieved elsewhere will not directly impact on our pension costs.

While we do not disagree with some form of incentive to manage the risk based element of the PPF levy, the cap of £0.4m for the risked based element and £0.1m for the fixed element appears arbitrary. The fixed element of the levy is wholly outside of the company's control and therefore we do not believe that any cap should be applied to this element.

6.2 Pension deficit payments

We recognise that the pension deficit costs in the initial proposals have been included only as a "marker" pending the outcome of the separate pensions consultation. However, there appear to be material errors in the figures used in the initial proposals. These costs have also been "deflated" for a second time to 2007/08 prices. The forecast deficit repair repayments within the DPCR5 period have also been spread over a standardised 10 year period, ignoring the fact that the DPCR5 figures submitted are for just the 5 years of the agreed 10 year deficit recovery period. The combined impact of these errors in the DPCR5 deficit allowance is in the region of £30m.

6.3 Regulatory fraction

We note that the regulatory fraction has been updated following our letter to Bill McKenzie on 9 June 2009, evidencing that our pension liabilities are 100% distribution. However, we are not clear why the percentage used is 92% when there is another DNO that has a 100% regulatory fraction.

6.4 Ex post adjustments for DPCR4 funding

We have been concerned about the late discussion on the treatment of actual pension costs incurred by the DNOs compared with the allowances. We welcome Ofgem's clarification on the proposed treatment for the DPCR4 true up but note that there are a number of errors in the calculation used for the initial proposals. We have provided a separate model showing how the pension true for DPCR4 should be adjusted in DPCR5 and welcome further discussion with Ofgem so that the DPCR5 revenue adjustments can be finalised without delay.

7 Revenue Allowances and Financial Modelling

7.1 Profiling of Revenues

Revenues need to be profiled to avoid significant cash flow difficulties for the DNOs. The only way to achieve this with rising investment is to apply a Po/X approach with the X set to zero from 2011/12 or match revenues to costs. Further benefits of a Po/X approach are that this would provide stable real prices after the first year and the method is understood by customers, since this approach was applied at DPCR4.

7.2 Structure of the Price Control

We have been in discussions with Ofgem on a number of issues relating to the proposed structure of the price control. We note that there are some areas where Ofgem has not made a decision or further details are required, most noticeably possible adjustment for the cost of debt (see Chapter 1 for our views) and the operation of the new arrangements for transmission exit charges (see our response to the Environment and Obligations consultation).

7.3 Financial Modelling

Although there has been good progress in recent months we are disappointed to have found material residual errors in the financial model used by Ofgem for the initial proposals. We note that this follows an external audit of the model by PKF. We welcome the sensitivity testing you are carrying out on the financials of the DNOs. DPCR5 is a considerably more uncertain environment than DPCR4 and Ofgem need to convince themselves that uncertainty in the financial markets and economic conditions have been fully tested in the financial model.

We do not agree with Ofgem's proposed approach to cap/collar the rate of return earned by the DNO. This would be to the detriment of customers, since it would dis-incentivise companies from improving customer service if additional revenues and returns are not available. In this respect, the purpose of the price control is to set an allowed return at least equal to the WACC, recognising that companies need to maintain returns above the RORE allowed in the WACC.

It would be helpful if you could share some of the monte carlo simulation results they have been using with the DNOs and allow DNOs to comment on the key input parameters.

7.4 Financeability

Rating agencies and other regulators use a broad range of financial ratios to assess the financeability of utility companies. We are disappointed that you have not acknowledged our request for inclusion of an adjusted interest cover / post maintenance interest cover ratio in the financeability test or explained the reason for its omission. As we have previously raised in earlier consultations this ratio is extensively used by credit rating agencies as an important measure of financeability for utility companies and is increasingly used in debt covenants. The results of the recent ENA/Ofgem investor survey identify the importance of this ratio. We also note that Ofwat has acknowledged its use in its draft determination of price for the water

companies issued on 23 July 2009. We believe that investors need to be confident in the regulatory regime and thoroughness of regulatory processes and therefore request that Ofgem consider the full set of ratios used by the financial community.

We specifically refer Ofgem to a recent publication by Moody's Investors' Service Limited entitled: Moody's Rating Methodology Regulated Electric and Gas Networks, published in August 2009.

In this we note Moody's apply a 40% weighting to a utility's Key Credit Metrics (ratios) and that specifically the adjusted interest cover ratio represents 15% of the overall assessment weighting. The target ranges published are 2x-4x for a A3 and 1.4x to 2x for a Baa1.

On credit ratings the competition commission (CC) concluded in the recent case of Stansted Airport that a rating of BBB+ would be insufficient in current market conditions. The CC stated:

"Given that there was an inevitable degree of uncertainty about the way that debt market conditions will evolve in the coming years, this suggested to us that an efficiently financed company might seek to target an A3/A– rating in the current market climate."

This conclusion has been supported by Ofwat in their recent draft determination. We believe the target values set by Ofgem for the key ratios are close to BBB+ and therefore insufficient to ensure 'comfortable investment grade' in the current climate. It is important for Ofgem to fully stress test the financial model in terms of cost shocks, changes in RPI and changes in other economic and financial conditions and the consequential impact on the financeability test. Ofgem has cut forecast expenditure for DPCR5 and a test that simply ignores all costs Ofgem consider to be 'inefficient' is meaningless, since these costs will not disappear over night. There needs to be an appropriate allowance for the time it will take companies to reduce these costs.

7.5 Base Revenue Allowances

We have a number of issues with the calculation of some of the base revenue allowances. These have been the subject of separate discussion with Ofgem. We would urge Ofgem to resolve the outstanding issues as quickly as possible. The wording in the initial proposals is unclear regarding the treatment of transmission exit charges but we now understand that these cost are excluded from the base revenue allowances.

In terms of the presentation of base revenue allowances we would suggest that pass through costs should appear as part of total costs on row 21.

7.6 Chapter Questions

Q1: Do respondents agree that we have appropriately identified the scope of the price control, i.e. are we making allowances for the right categories of cost?

A1: We believe that the scope of the price control in the initial proposals is appropriate.

Q2: How do respondents think we should profile allowed revenues over the 2010-15 period?

A2: See Section 7.1 above.