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storage

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Hannah Nixon
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Dear Hannah,

Object: Centrica Storage Limited's response to Ofgem Consultation on "Regulating energy networks for the future: RPI-X@20 Recommendations" (ref. 91/10)

Centrica Storage Limited (CSL) welcomes the opportunity to participate in the consultation process for Transmission Price Control Review 5. Please refer at this document as a non-confidential response to Ofgem "RPI-X@20 Recommendations" (ref. 91/10).

CSL is currently the operator of Rough storage facility and thus, we interact daily with the Transmission System Operator (TSO) as a shipper, withdrawing and injecting gas into the National Transmission System (NTS) at the relevant exit and entry point. In the previous TPCR, CSL took a leading role, chairing the Gas forum and developing proposals on regulated companies' financeability. We look forward to take active part also in the coming review, providing useful comments and suggestions.

In summary, we believe the proposed recommendations have the potential to deliver a more efficient and consumer focused regulatory framework for transmission operators. However, we would like to raise concerns on some aspects of the high-level objectives proposed by Ofgem.

Following the structure of the consultation's supporting paper , we like to offer comments on the following issues:

1. extending the regulatory lag to eight years (*chapter 5*)
2. output and efficiency incentives (*chapter 9, 10*)
3. managing uncertainty (*chapter 11*)
4. financeability (*chapter 12*)

1. Extending the regulatory lag to eight years

The ex-ante fixed regulatory lag in RPI-X regulation has always given to regulated companies a proper incentive to use production factors in efficient proportions. In theory, the longer the lag, the stronger the incentive to maximize technical efficiency in order to maximize profits. However, the setting of a mid-year review could reduce this positive effect, since companies will perceive the possibility of reducing values and, thus, incentives.

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2. Output and efficiency incentives

Ofgem proposes to allow the allowed revenue cap to vary according to company performance in delivering output measures. Whilst we support the effort to link regulatory incentives to measures which are directly perceived as consumer focused, we ask Ofgem to ensure full transparency on the impact of revenue adjustments over final charges. We also expect regulated companies to be ready (through business plans) to consistently demonstrated the feasibility of achieving such outputs over the regulatory period.

Introducing "upfront efficiency incentives" Ofgem aims to let investors and consumers share the potential benefits/costs of under/over-performing the targeted spending budget, which will be set out at the review in advance for the regulatory period (*§10.6*). Considered individually, we believe the mechanism will provide a strong incentive to over-perform during the period in order to maximize companies' reward, also letting consumer to share part of it. However, since the mechanism has to be viewed in the more complex framework of setting the allowed revenue cap, we suggest that Ofgem provides a reasonable forecast of the interaction with all other incentive mechanisms and how the desired outcomes will be achieved.

3. Managing uncertainty

CSL welcomes the use of efficiency incentives to split the risk of cost increases by exogenous factors between investors and consumers, because it should fairly reflects the balance between investors' private interest to hedge uncertainty of their return and public needs for guaranteeing security of supply.

As well, CSL welcomes the introduction of new mechanisms for reducing uncertainty during the regulatory period. However, we have to note that the higher the number of mechanisms, the more difficult it will be the understanding of charges responding to the outcome of such mechanisms (thus, lower the regulatory transparency)

With regard to the indexing mechanism (*§11.54*), since Bank of England decided to introduce a new measure for the inflation rate (CPI index), we agree with Ofgem that the energy industry should undertake the same methodology, when needed (like in regulating transmission charges). We understand the many difficulties to practically implement this new approach into TPCR5 because of a current lack of CPI-indexed bonds. We therefore suggest starting considering the use of CPI index in all aspects of the control review, subjecting its final implementation to the existence of CPI-indexed bonds on the market.

With regard to managing volume uncertainty (*§11.60*), we believe that mechanically computing allowed revenues as a function of volume measures (*table 9, mechanism 1*) would create incentive to over-create connections, even where not necessary. We wonder whether this distortion would be corrected by any other mechanism within the control review. On the contrary, eventual adjustments made at the occurrence of a certain event (*table 9, mechanism 2*) are already subjected to planning permission, so any distortion would be corrected by the authorization of an external body. As well, adjustments made during and after the control review, will be subjected to Ofgem revision (*table 9, mechanisms 3 and 4*).

4. Financeability

Ofgem has anticipated a lower cost of capital for the next review, partially due to the increase in the regulatory transparency and commitment (*impact assessment, §3.18*). As theory, CSL believes that an increase in regulatory commitment would decrease investor uncertainties and, thus, the return on capital they require for investing. Nevertheless a lot of supporting documents are provided on the approach for assessing the cost of capital, we ask Ofgem to provide a more detailed explanation on the reasons that have driven down the forecast on the cost of capital.

Ofgem proposes to assess the cost of debt based on a backwards looking long-term trailing average of forward rates, mechanically adjusting the value every year (*§12.23*). We welcome Ofgem moving away from the previous “headroom” approach, since it was creating unnecessary uncertainty. Proposing the new approach, Ofgem relies on the evidence that the allowed return on debt in the last five control reviews has very closely tracked the long-term average. However, because the recent financial crisis deeply destabilized the short-term volatility of debt premium and the cost of utility debt still faces a systematic component (even if lower compared to other industries), we suggest Ofgem a stronger indexation mechanism, accounting for exogenous signals of eventual considerable changes of the trend, in order to ensure regulated companies the financeability of their business plan.

Ofgem intends to allow a fixed percentage of total expenditures (TOTEX) to be capitalised into the RAB, instead of the total amount of capital expenditures (CAPEX) (*§12.29*). This approach has been proposed since the same incentive rate has been chosen to be applied to both yearly CAPEX and OPEX (*§10.8*), which in turn should solve any perverse allocation between CAPEX and OPEX (*§box 10*).

However, we are particularly concerned that the proposed framework will incentivise regulated companies to under-invest in period when the market cost of capital will be higher than the allowed WACC, and vice versa to over-spend (in both OPEX and CAPEX) when the market cost of capital will be lower than the allowed WACC.

Moreover, since annual NTS charges are based on the split between capacity and commodity charges, moving away from the distinction between CAPEX and OPEX will make even more difficult to link current charges to allowed revenues in any future methodology.

We urge Ofgem to offer TPCR stakeholders a deeper analysis on the interactions between the proposed efficiency incentives mechanism, capitalising costs into the RAV and computing ex-ante the WACC without short-term market indexing; given the importance of incentivizing a significant amount of investments over the coming regulatory period, we expect Ofgem to offer a reasonable forecast of the impact of these proposals over the investment plans of regulated companies, particularly looking at the differences with the previous arrangement.

To better understand such interactions, we suggest Ofgem to consider, in the next consultation documents, the following issues:

- ✓ explain whether the efficiency incentives will adjust the RAV value before the computation of allowed revenues or the allowed revenues after the fixed percentage of TOTEX has been capitalised into the RAV (*§10.18*);
- ✓ define in details an high-level formula, including rates fixed ex-ante and incentives, which explain how the allowed revenue will be computed, so that

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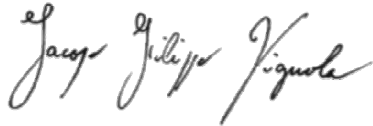
real incentives (or distortions) could be easily identified simulating different scenarios.

We hope that you have found these comments useful and please do not hesitate to contact us if you wish to discuss the response further.

Your sincerely,



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