



*Promoting choice and value for
all gas and electricity customers*

Electricity distribution companies,
transmission companies,
generators, suppliers, customer
groups and other interested parties

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Dear Colleague,

Decision letter on the regulatory asset lives for electricity distribution assets

In our December consultation as part of the RIIO-T1 and GD1 price controls¹ we published an asset life report we had commissioned from a consortium led by Cambridge Economic Policy Associates (CEPA)². This report made proposals for economic asset lives for all energy sectors, including electricity distribution. On 14 January 2011, we issued a separate consultation letter on regulatory asset lives for electricity distribution assets³ in recognition of the importance of this issue to electricity network owners and to provide clarity on our proposed approach as early as possible.

Following consideration of the consultation responses, the Gas and Electricity Markets Authority ('the Authority') has decided that we will use an average expected economic asset life of 45 years for new assets, with straight-line depreciation. The new asset life will only apply to new investment from the commencement of RIIO-ED1 on 1 April 2015. Existing assets will continue to use the existing 20 year asset life.

We are committed to ensuring that efficient networks are able to raise the finance they require, both equity and debt, in a timely manner. We recognise that, even with the policy of applying the change in asset lives to new assets only, transitional arrangements may be required and that these may need to be over more than one price control period. Companies will have the opportunity to fully demonstrate, in their business plans at RIIO-ED1, the transitional arrangements that they believe are necessary to ensure financeability.

The remainder of this letter, which is issued alongside our decision on the strategy for the next transmission and gas distribution price controls - RIIO-T1 and GD1⁴, sets out a summary of the responses to our consultation letter of 14 January 2011 together with the rationale for our decision.

¹ <http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/T1%20and%20GD1%20finance.pdf>

² The Economic Lives of the Energy Network Assets – A Report for Ofgem. Cambridge Economic Policy Associates (CEPA), Sinclair Knights Merz (SKM) and GL Noble Denton. December 2010.
<http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/CEPA%20Econ%20Lives.pdf>

³ <http://www.ofgem.gov.uk/Networks/Policy/Documents1/ED%20asset%20lives%20consultation%201000114.pdf>

⁴ Decision on strategy for the next transmission and gas distribution price controls - RIIO-T1 and GD1 Financial issues <http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/T1decisionfinance.pdf>

Summary of our open letter consultation

In our consultation letter, we set out our intention in the next electricity distribution price control to follow the RIIO principles of using the average expected economic asset life for regulatory depreciation.

We proposed, for consultation, an average economic life for the electricity distribution network of 45-55 years for all assets. This would extend asset lives from the current regulatory asset lives of 20 years. We also gave details of the existing average age of the network (39 years), details of useful economic lives used in the accounting policies of the network operators (10-80 years) and also summarised the work CEPA had completed in their report on the technical (73 years weighted average) and economic lives. We also consulted on the proposal to continue with a straight line depreciation profile.

We re-iterated our commitment to ensure that efficient network companies will continue to be able to finance their activities (which are the subject of obligations on them)⁵. We noted that if the adoption of a new approach to depreciation in a single step would raise concerns about financeability, we would agree appropriate transition arrangements with the companies concerned.

We stated our expectation that network operators would propose transitional arrangements as part of their well-justified business plans for RIIO-ED1, the next electricity distribution price control.

Summary of responses

We received a good response to our consultation from a wide range of stakeholders. Consumer groups were supportive of our approach, whilst network companies were concerned about the potential impact on cash flows, particularly if our proposal were applied to existing assets.

Two network operators and consumer groups agreed that it was appropriate to apply economic asset lives to regulatory depreciation and broadly supported the range proposed. The other network operators generally did not support the use of economic asset lives and virtually all of the networks operators suggested our proposals should be not applied to existing assets.

As with our electricity transmission consultation other arguments that were raised were; that we had failed to sufficiently demonstrate why existing regulatory depreciation period needed to change, why economic asset lives should be used and that our proposals were removing costs from the current generation of consumers, who had already benefited from pre-vesting discounts, and increasing costs on future generations.

Most operators accepted that if we had to make a change then we should decide on that change now. A couple of network operators raised concerns about making a decision on asset lives in isolation of the other aspects of the price control package. One network operator raised concerns that insufficient warning of changes to asset lives had been given.

There was agreement from most operators that a straight line depreciation profile should be retained.

⁵ Ofgem's duty has not changed as a result of RIIO.

There were a number of proposals put forward for transitional arrangements, which included applying new asset lives to new assets only, transitioning over more than one period, changing the fast/slow money split and increasing the cost of capital.

Appendix 1 provides a summary of the responses received.

Our decision

Timing of our decision

We are mindful from the responses we have received that the process for RIIO-ED1 has yet to commence and that asset lives are only one part of the price control package. We consider that as we had to look at the asset lives of transmission and gas distribution assets as part of the RIIO-T1 and RIIO-GD1 price control reviews, it was efficient (in terms of our use of consultants) and responsible also to examine electricity distribution asset lives. Reaching a conclusion now on the lives of electricity distribution assets will avoid the speculation and uncertainty which would otherwise have arisen once we had decided on the lives of gas distribution and transmission assets.

We also think that taking a decision at this point, well ahead of the start of the next electricity distribution price control review, will also give the DNOs time to begin making adjustments and provide the certainty they need in dealing with their investors in the run up to RIIO-ED1.

RIIO approach to asset lives

A key element of the RIIO principles is the use of economic asset lives as the basis of the regulatory depreciation period. Some network operators raised concerns as to the appropriateness of the use of economic asset lives and the impact on inter-generational equity. These concerns were also raised in response to the RIIO-T1 consultation and our responses to them are addressed in more detail in the March decision document⁴ and in particular the Financial issues supplementary annex.

The existing regulatory asset lives were introduced to address a specific issue and were not representative of economic asset lives. As long ago as Nov 2004 in the DPCR4 final proposals⁶ we stated that in the longer term, electricity distribution asset lives should more closely reflect the useful or economic asset life.

The RIIO approach of using economic asset lives to determine the regulatory depreciation profile represents a sustainable long-term policy. It should also give investors more certainty over Ofgem's decisions than the current 20 year depreciation period which could otherwise lead to a "cliff edge" situation where the revenue earned by the distribution companies falls precipitously.

In summary we believe, as discussed during the development of the RIIO principles, that depreciation based on economic asset lives is appropriate and will provide for sustainable financeability over the longer-term, improved longer-term intergenerational equity and better longer-term pricing signals.

⁶ Electricity Distribution Price Control Review: Final Proposals, November 2004 Ofgem. Paragraph 8.13

Decision on asset lives

Our decision is that we will use an average expected economic asset life of 45 years for electricity distribution assets. We considered a number of factors in arriving at this decision and they are set out below.

- CEPA's report issued with our December consultation assessed detailed technical lives for the components of the existing networks. This gave a weighted average technical asset life of 73 years (51 years if underground cable are excluded). The technical lives used for existing assets have not been queried by network operators.
- CEPA analysed the average existing age of the network. This shows that the current weighted age of the network is already 39 years. The network operator's statutory and regulatory accounts use an assessment of useful economic asset lives of between 10 to 80 years with the bulk between 30 to 60 years.
- Our proposals were supported by consumer representatives and two network operators supported the approach and the broad range for asset lives.
- By using an economic asset life of 45 years, which was at the bottom of the range we consulted on, we believe we have made sufficient allowance for the potential future increase in the mix of shorter life economic assets. These shorter life assets would include those with inherently shorter economics lives or those that would have their economic lives curtailed for other reasons, including changes flowing from the introduction of new (for example, smarter) technology and changes in customer behaviour.

Decision on applying to new assets only

We have decided to apply the new asset lives to new investment from the start of RIIO-ED1 on 1 April 2015.

In arriving at this decision, we have listened to the arguments raised in response to our consultation, including the concerns about the impact on intergenerational equity that has already arisen from the valuation of assets at vesting. All operators highlighted that they may face financeability problems if this change were to be applied to existing assets.

We have also taken note of respondents' views. A number quoted from The Department for Business and Skills (BIS) on the 'Principles for Economic Regulation' and in particular that "the framework of economic regulation should not unreasonably unravel past decisions...."

While we think there are reasonable grounds for applying the change in asset life to existing assets, including the fact that we have long signalled our intention to consider this aspect of the regulatory framework, on balance, we have had regard to our financing duty and the RIIO principles of not creating shocks or instability. These persuade us that in this case we should not apply the new asset lives to existing assets.

Transition

We have already received a number of modelling scenarios from electricity distributors with suggestions for transition arrangements. Although we cannot review these in detail at the current time, we acknowledge that it may be appropriate to phase in the new asset lives over one or more price control periods.

Our aim is to put in place longer-term policies based on fundamental principles to provide for financeability over the longer-term. We are confident that we can put in place transition arrangements to deal with short-term financeability concerns during RII0-ED1

Please contact Peter Trafford at peter.trafford@ofgem.gov.uk or on 0207 901 0510 if you have any queries in respect of issues raised in this letter.

Yours faithfully,

Rachel Fletcher
Partner, Distribution

Appendix 1 – Summary of responses to open letter consultation

We received 13 responses including all the electricity distribution network operators, other network operators, consumer groups and other interested parties.

Average economic asset lives

Two network operators agreed that it was appropriate to apply economic asset lives to regulatory depreciation and broadly supported the range proposed.

Consumer groups and one other respondent agreed with our asset life range and supported our proposals to use economic asset lives

One network operator and one other respondent acknowledged that there was a strong case for the reform of networks financing.

One network operator agreed that technical lives were longer than 20 years.

Several network operators commented on the impact that short life technology assets and embedded generation would have a material impact on the average technical lives. They stated that they did not believe that the proposed asset life range was reflective of the future network asset life.

One respondent suggested the use of a more complex formulation of asset lives, rather than a single simple average for all assets, would actually prove less complex to operate and take account of the diversity of assets used in the network.

One respondent suggested that the concept of economic lives needs to include risk considerations and depreciation schedules need to match failure distributions of the underlying assets.

Other network operators did not support the use of economic asset lives in setting regulatory asset lives making various comments:

- One network operator stated that regulatory asset lives are not the same as statutory or economic asset lives and that they are a complex financial instrument.
- One network operator did not believe they were in the best interests of consumers, investors or the wider industry.
- One network operator stated that it is necessary to front-load the regulatory depreciation profile as the uncertainties associated with assets whose service life is measured in decades are very considerable in the later years. The use of 20 years represented a balance between what we know and what we don't know.
- One network operator suggested that we had failed to sufficiently demonstrate why existing regulatory asset lives needed to be changed and why economic asset lives should be used.

Virtually all of the network operators suggested that our proposals should not be applied to existing assets.

Straight line depreciation profile

There was explicit agreement from almost all the respondents that a straight line profile should be retained.

Transitional arrangements

A number of different proposals were put forward for transitional arrangements from various network operators:

- applying the new asset lives to new assets only (following the 'grandfathering principle').

- transition periods of more than one price control would be needed.
- changing the ratio of fast and slow money by increasing the slow money component.
- suggesting an increase in the cost of capital would be needed to compensate for the increase uncertainties of the cash flows.

Consumer groups were of the view that the onus was on network operators to demonstrate the need for transitional arrangements.

Other issues raised

A number of network operators stated that we were removing costs from the current generation of consumers, who had already benefited from pre-vesting discounts, and increasing costs on future generations.

A couple of network operators raised concerns about making a decision on asset lives in isolation of the other aspects of the price control.

One network operator raised concerns that insufficient warning of changes to asset lives had been given.

One network operator suggested that the principle that regulatory lives should reflect expected economic lives was still a policy intent and has not yet been established into practise.