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Dear Peter,

Open letter consultation on the regulatory asset lives for electricity distribution assets (Ref. 04/11)

National Grid welcomes the opportunity to respond to this open letter consultation.

Our response of 4th February to Ofgem's Initial Strategy Document for RIIO-T1 explained our grave concerns regarding the financeability elements of the proposals, including the reasons why the proposed changes to the asset lives used in calculating the regulatory depreciation in electricity transmission are not justified. We similarly believe that there are strong reasons why changes should not be made to the regulatory asset lives used in electricity distribution.

Our fundamental objections to the proposed changes to electricity asset lives are that:

- To date, Ofgem has failed to demonstrate why asset lives need to be extended. (The failure to do this has provoked a negative reaction from investors.)
- Ofgem has not demonstrated why the considerations that led to the original decision to apply a 20 year asset life to post-vesting assets in electricity – and which still apply today – can now be disregarded.
- The intergenerational balance of charges (“intergenerational equity”) is only one factor that should be taken into account in considering asset lives: there are other considerations that are as important or more important.
- Even on the basis of intergenerational equity, increases in electricity asset lives are not justified: for the reasons that National Grid and other networks have previously explained the proposed change can be expected to make less fair the balance between charges to consumers in the short and longer term.
- The proposed change would go against the key principles of predictability, transparency and consistency, which are essential for investor confidence, and where loss of investor confidence will increase the cost of capital to the detriment of current and future consumers.
- The proposed change would unreasonably unravel past decisions, and is contrary to good regulatory practice and the principles for economic regulation set out in the recent BIS consultation on economic regulation.
- The proposed change will increase perceptions of regulatory risk and as a result the required level of return: the change is not NPV neutral but will increase costs to current and future consumers, taken together.

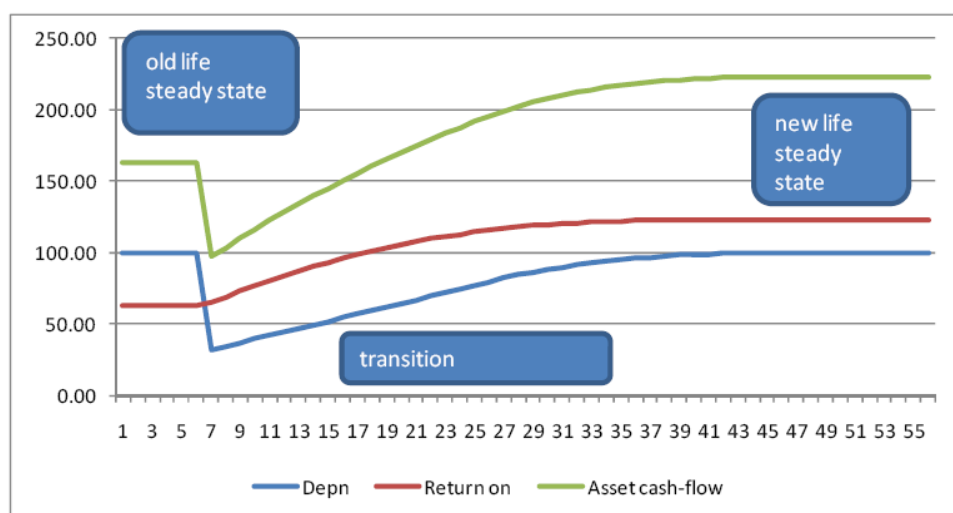
In addition, as Ofgem have noted, the proposed increase in asset lives is likely to have a significant adverse impact on financeability, which in our view is out of proportion to any benefit that has or could be claimed for the proposed change.

Given the similar considerations that must be taken into account in determining asset lives in electricity transmission and electricity distribution, we also refer you to our previous responses¹ which have raised a number of principled and practical reasons why the change should not be made, many of which Ofgem has not yet addressed. We similarly draw your attention to other stakeholder responses, in particular those from other networks, which express reservations over the proposed changes to electricity asset lives and the basis on which the proposed change has been reached.

1) The Impact of Changing Asset Lives

The effect of the change in electricity asset lives which Ofgem are proposing is shown by the stylised illustration at Figure 2.10 of Ofgem’s recent RIIO-T1 and GD1 Financial Issues consultation, which is reproduced below:

Figure 2.10 Stylised example of the impact of extending asset lives on depreciation, the return on RAV and the combined cashflow



Source:

CEPA

Although this illustration was used in the RIIO consultation to show that transitional arrangements may be needed if asset lives are changed, the real question it raises is why does the asset life need to be changed at all?

In addition, even with transition arrangements (see the figure overleaf, which reproduces Figure 2.11 from the RIIO-T1 and GD1 Financial Issues consultation) a change to asset lives creates unnecessary fluctuations in network revenues and charges to customers/consumers: why are these desirable when continuing with the original life is a perfectly viable alternative which, in this example, would maintain cashflow at the initial level?

¹ For example:

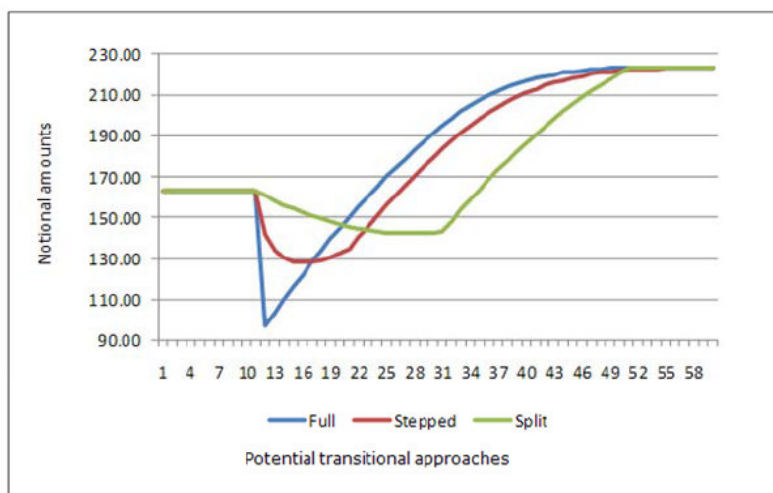
<http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/NG%20response%20-%20Emerging%20Thinking%20General%20-%20Embedding%20financeability%20in%20a%20new%20regulatory%20framework.pdf>;

<http://www.ofgem.gov.uk/Networks/rpix20/WorkingPapers/Documents1/NG%20Financeability%20Response.pdf>;

<http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/National%20Grid%20response.pdf>;

http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/National_Grid_Transmission_cover_letter.pdf, and see also the full response submitted by National Grid in response to the RIIO December consultation

Figure 2.11 Illustrative cashflow impact of different approaches to transition



Source: CEPA

It is also clear from this example that making a change to asset lives distorts the balance of charges between different generations of consumers, whereas continuing to use the original asset life would fairly balance the charges to consumers in the years after the change and in the longer term. Why should asset lives be changed to give a short-term reduction in charges followed by higher charges in the longer term, and why does Ofgem believe that this would improve the intergenerational balance between different generations of consumers?

Ofgem has not answered these fundamental questions.

2) Background

Ofgem's original reasons for adopting 20 year asset lives for post-privatisation electricity assets, initially in distribution and then in transmission, were explained in the relevant price control documents. These were:

- The impact on path of prices to consumers, and the preference to avoid “a sharp fall in depreciation after 2000, followed by increasing allowances in the longer term.” (see Distribution Price Control Review Final Proposals, December 1999 paragraph 5.33)
- The resulting choice of 20 years for the depreciation asset lives was seen as “a means of increasing certainty with respect to the financial position of the distribution businesses and the path of prices in the longer term. **The benefits of this will be felt by both customers and companies.**” (see Distribution Price Control Review Final Proposals, December 1999, paragraph 5.34)
- In Transmission, the explanation in TPCR4 referred back to the DPCR3 decision, “For the electricity distribution companies, in DPCR3 and DPCR4, we [Ofgem] concluded that an adjustment should be made to smooth the profile of depreciation and remove this “cliff edge” effect. We have adopted this approach in our updated proposals.” (see Transmission Price Control Review Updated Proposals, September 2006, paragraph 8.36)

The effects of an increase in post-vesting depreciation asset lives which Ofgem now propose would be exactly those which, as explained above, the original choice of 20 years sought to avoid: it would give a “sharp fall in depreciation followed by increasing allowances in the longer term”; it would reduce the “certainty with respect to the financial position of the distribution businesses”; and it would affect the “path of prices in the longer term”. As Ofgem previously explained, these effects are detrimental to consumers. Ofgem has not explained why its previous decisions on asset lives in 1999, 2004 and

2006 were wrong, nor why the considerations that applied in these earlier price controls are no longer relevant.

The new consultation letter² suggests that the DPCR4 Final Proposals document signalled that the 20 year regulatory asset life would be subject to a future review, and reproduces the following paragraph:

*“In the longer term, it would be reasonable to expect the price control treatment of long-lived assets to more closely approximate to their useful technical or economic lives, for example so that the customers that pay for an asset are those that derive benefit from it. **Were it not for the peculiarities of pre-vesting asset lives and the need to maintain broadly stable financial profiles**, it seems unlikely that 20 year lives would be optimal. Ofgem will want to review this issue at the next review in the light of these considerations.”*³

Clearly, “*the peculiarities of pre-vesting asset lives*” - and now also the application of 20 year asset lives to post-vesting assets which was itself a direct consequence of the pre-vesting asset lives - still affect the value of RAV, and it remains just as important to “*maintain broadly stable financial profiles*”. Thus, the paragraph cannot be taken as signalling that any review of asset lives would lead to a change from 20 year asset lives, and the words highlighted above create a clear expectation that in any review of electricity distribution asset lives *the peculiarities of pre-vesting asset lives* and the need to *maintain broadly stable financial profiles* would be given full weight.

Moreover, the decision to adopt 20 year asset lives in electricity transmission only took place after DPCR4 and the above paragraph was published, with no indication being given in the TPCR4 Final Proposals that this would be subsequent to future review. At the least, this TPCR4 decision supersedes the above paragraph, but it could also and quite reasonably be taken as confirmation of the use of 20 year asset lives and the reasoning that led to this approach in both electricity distribution and transmission.

3) RPI-X@20 and RIIO Consultations and Responses

Within the RPI-X@20 review, Ofgem raised the idea of making changes to electricity network asset lives in the January 2010 “RPI-X@20 Emerging Thinking - Embedding Financeability” consultation, suggesting that the following criteria need to be considered:

- Transparency and predictability
- Balancing the interests of current and future consumers
- Price signals and cost reflectivity – how important is it that consumers and users face appropriate price signals
- Incentives (i.e. impact on incentives faced by networks)
- Reliance on cash flow ratios (and whether this is necessary and appropriate)

There was then further consideration of the issue in the May 2010 “Financeability - Current thinking working paper”, and the July 2010 RIIO Recommendations document.

In response to all these consultations National Grid and other networks put forward strong objections to the proposed changes. These included both practical considerations (see later) and more fundamental objections of principle, including the following. (Although in most cases only a single organisation is identified below against each of the considerations listed here, similar points have often been made by more than one company.)

- Intergenerational fairness can only be considered by taking a number of different aspects of price controls into account, including the treatment of inflation (i.e. allowing real returns, with

² “Open letter consultation on the regulatory asset lives for electricity distribution assets”, Ofgem, 14 January 2011.

³ The Ofgem consultation letter of 14th January 2011 contained an extract of the DPCR4 Final Proposals paragraph 8.13 which it refers to, which omits some key words including those shown here highlighted. For complete clarity, the full paragraph has been reproduced here.

the inflationary element being rolled up into future RAV), and does not depend on depreciation asset lives alone. (National Grid, Central Networks)

- Even on the narrow basis on which Ofgem have approached intergenerational fairness, the basic argument that electricity asset lives should be increased is flawed. It is not the case that “existing consumers [are] paying more for the assets than future consumers”⁴ as the graphs of network revenue that have subsequently been produced by Ofgem’s consultants clearly show.⁵ With rising RAVs and hence rising bills for future consumers, it is difficult to assert that current consumers are paying “too much”. (National Grid, SSE)
- The choice of asset life to achieve intergenerational fairness cannot be considered on a “single asset” basis but needs to consider all the assets that contribute to the services provided to consumers. For example, current electricity consumers continue to benefit from the large numbers of pre-vesting assets which are now fully depreciated in the RAV. This appears still to be ignored in the recent analysis that has been carried out by Ofgem’s consultants, undermining the analysis and any conclusions on intergenerational effects that have been drawn from it.⁶ Whilst it is true that a future change in asset life (from 20 years to 40 years say) would give a 1-off temporary reduction in charges, this is just a feature of changing the approach and does not reflect a switch to a level of charges that, on an objective basis, is the “right” level of charges. Neither would such a change correctly balance the charges faced by current and future consumers. (National Grid)
- Lengthening the depreciation periods would not better balance the interests of future and current consumers: existing DNO RAVs are only around 17% of the Modern Equivalent Asset Values of the assets being used by current consumers, meaning that current consumers are, in fact, paying too little for the services they receive, and any lengthening of asset lives would add to the existing underpricing of current DNO services. (EdF)
- The financeability proposals (including the change to asset lives) would deny a licensee “top line” revenue at precisely the time that it needs to invest in the business, on the strength of a promise that it will be able to recover these amounts in the future when it no longer needs the cash. This policy is misconceived: the promise of repayment in future years lacks credibility and there is nothing that Ofgem can do to overcome this. (CE Electric)
- In electricity distribution, the original RVs were “too” low from an economic perspective (i.e. below the economic value or modern equivalent asset value) – and so reduced depreciation lives were needed to ensure an adequate business cash flow. (CE Electric)
- The proposal to lengthen regulatory depreciation lives would visit on future generations the price consequences of the investment decisions that we are being urged to make today and in the immediate future (CE Electric).
- Future consumers will be burdened with paying for any changes required by the facilitation of a low carbon network. (Central Networks)
- There is merit in a shorter asset life than the service life of the asset because this will send a sharper signal to consumers, regulators and licensees on the price consequences of investment. The scale of investment that is expected over the next 20 years is clearly indicative of a tightening demand-supply balance on the networks and, far from considering a longer regulatory depreciation period, Ofgem should be considering whether a higher effective depreciation rate would be appropriate in order to strengthen the price signal being sent to current customers. (CE Electric)

Some networks have also noted the nature of the RAV and that as a result there can be no presumption that depreciation asset lives should match economic useful lives:

- The existing RAV of network businesses is a financial/regulatory construct that is removed from the intrinsic value of the physical assets, and the depreciation asset life which is applied

⁴ This assertion - made at paragraph 12.32 of “Regulating energy networks for the future: RPI-X@20 Recommendations: Implementing Sustainable Network Regulation”, Ofgem, July 2012 - appears to lie behind the proposed change to regulatory asset lives in electricity.

⁵ “The Economic Lives of Energy Network Assets: A Report for Ofgem”, CEPA, December 2010, see for example figures 7.2, 7.5, 7.14 – 7.16

⁶ “The Economic Lives of Energy Network Assets: A Report for Ofgem”, CEPA, December 2010

to a RAV is similarly a regulatory construct. If going forward depreciation is to reflect more accurately the actual life of the assets, then for consistency the RAV should match their intrinsic value, and Ofgem would need to revalue the RAVs to a current cost basis. (SSE)

- Depreciation does not need to reflect expected asset service life for network assets – it would be helpful for Ofgem to use the vocabulary of “payment terms” rather than “depreciation periods”. (CE Electric)
- The RAV is a financial construct which was created at privatisation and the different depreciation periods used since then mean that today’s RAV value is not representative of the physical asset base. Changing the depreciation period to represent actual useful life is unlikely to create the intergenerational fairness Ofgem propose. The current 20 year depreciation period may mean that current consumers are paying more for post-vesting assets that future consumers will also use than they otherwise might, but they benefit from the fully depreciated pre-vesting assets. It is not clear that current or future consumers, in the round, will be paying an unfair amount for distribution under the current asset lives. (Central Networks)

The practical considerations that have been raised include the following:

- Increasing the duration of returns to consumers increases the cost of capital, and as a result even in principle the proposed change is not NPV neutral;
- Increasing the duration of returns also increases regulatory and political risk faced by the networks, which will further increase the required cost of capital. This includes the “time inconsistency” effect.
- The proposed change to asset lives would have an adverse impact on financeability.
- The proposed change to asset lives is likely to have a negative impact on financial ratios used in assessing credit ratings.
- The proposed change will also undermine regulatory consistency which is an important element of rating agency considerations in its own right.

Ofgem failed properly to address and respond to these points, and instead repeated in the October 2010 RIIO Handbook an intention to set the asset lives used in calculating regulatory depreciation [solely] on the basis of reflecting “*the expected economic life of the related network assets*”. Notwithstanding that this is now described by Ofgem as a principle that has been established, it is clearly not one that has been accepted by the affected networks. It is also not the principle that was actually set out in the RIIO Decision document⁷.

Even in the subsequent RIIO-T1 and RIIO-GD1 consultations and the accompanying CEPA paper⁸, and now the open letter consultation on DNO asset lives, the objections in principle to the proposed changes that have been raised by the networks have not been addressed. In fact, the CEPA paper presents evidence which adds strength to the arguments that the proposed changes to electricity asset lives are not justified and should not be made:

- CEPA present Modern Equivalent Asset Values for each of the network sectors. For electricity distribution the MEAV of almost £140bn far exceeds the current RAV (<£20bn). This suggests that current consumers benefit from an unsustainably low level of network charges, and that short-term reductions in the level of these charges (and/or delaying future

⁷ At Paragraph 7.6 of the RIIO Decision document Ofgem acknowledged the argument put forward by networks that the proposals don’t strike a fair balance between the charges to current and future consumers. Without addressing this argument in either the Decision document or supporting Implementation Handbook, Paragraph 7.8 simply stated “*We have decided to commit to the financeability proposals.*” However, the principle then set out in the Decision document is not that asset lives should match economic lives, but rather that they should fairly balance costs between consumers: the “Principles for financeability under the RIIO” on page 40 of the Decision document sets out the following, “*Depreciation: **When considering depreciation we will focus on how best to balance the costs paid by existing and future consumers, taking account of the expected economic life of assets and uncertainty in the future use (and usefulness) of assets.***”

⁸ “*Consultation on strategy for the next transmission and gas distribution price controls – RIIO-T1 and GD1 Financial issues*”, Ofgem, December 2010; and “*The Economic Lives of Energy Network Assets: A Report for Ofgem*”, CEPA, December 2010

increases in these charges) – which would be the result of the proposed changes to asset lives – cannot be justified when its legacy would be larger increases in charges for future consumers.

- CEPA's scenarios lead to expected increases in future electricity network charges (approximately four-fold increase from 2010 to 2050 in electricity distribution). In its executive summary CEPA notes that "*whilst under the existing profile we believe average consumer bills would be roughly constant (ignoring non-network investment issues) over the next decade or two, extending the electricity sector depreciation life would actually lead to reductions, albeit fairly small, during those periods prior to a more rapid increase in prices.*" This observation very much begs the question why a change to the current electricity asset lives is being proposed, as it would make worse (rather than improve) the inter-generational balance of the charges to consumers in the short and long term⁹.
- CEPA's paper raises the significant uncertainties that affect the future development of the energy sector as a whole. Against this background, deferring the recovery of essential investments in the networks in the years ahead (as well as of past investments in the networks) would seem ill-advised. With longer asset lives, the cumulative unrecovered investment in the RAV by the end of CEPA's scenarios (2050) will be very much greater. Given the length of timescales involved and needed for subsequent recovery of this RAV, and the inevitable technological, political, regulatory, social and economic uncertainties over these timescales, it is uncertain whether networks would be able to recover the significantly higher RAVs (that would result from longer asset lives) in the second half of the century, as Ofgem are unable to bind their successors to provide for such recovery.
- Figures 6.1 and 6.2 show the impact of changing depreciation asset lives on cash flows and depreciation: whilst CEPA suggest that these graphs raise the question of whether/how the cash flow impacts should be mitigated, the real question they raise is again why a change in asset life is being proposed in the first place.

It can be seen that compelling reasons not to change the asset lives used in calculating RAV depreciation in electricity transmission and distribution have been raised over the past year. Ofgem have a duty to consider and properly to answer these before making such a material change to a critical element of price controls. It is not sufficient to rely on a presumption and assertion that asset lives should match useful economic lives, when this assertion is itself undermined by a number of considerations which have been brought to Ofgem's attention. It is also not sufficient to rely on transition arrangements, as at best these can only mitigate the short-term impact of the proposed changes and they do not address the fundamental issue of whether a change in asset lives is justified.

4) Impact on Investors

Ofgem's failure to demonstrate why asset lives need to be extended has provoked negative reaction amongst the finance community. Investors are asking 'why do asset lives need to be extended?' and it is clear that Ofgem has not adequately demonstrated or communicated this need. The extension of asset lives is a key concern to investors that is undermining their confidence to invest in the sector. Ofgem must demonstrate how their proposals help to solve intergenerational energy price inequality and make this analysis available for critique before implementing any changes. Without this supporting evidence, regulatory risk, in this case the perceived risk of the regulator making further unwelcome

⁹ CEPA's analysis in "*The Economic Lives of Energy Network Assets: A Report for Ofgem*", December 2010 for electricity transmission (e.g. Figure 7.5) illustrates that changing asset lives will create an imbalance in charges to different generations of consumers. The pattern is less clear in electricity distribution (see e.g. Figure 7.2), though even here the projections of network revenues do not form a case for changing asset lives. However, these results in electricity distribution depend on the assumption that capex will continue to grow rapidly throughout the next 40 years, to a level of £5bn to £7½bn p.a. from just over £1bn today (see Figure 5.2). Sustained growth in investment to such a level must be far from certain, and under lower capex scenarios the distortion in the path of prices that is illustrated in Section 1 above would be more apparent, as CE have illustrated in their February 2011 response to the RIIO-T1 consultation.

and unnecessary changes to the regime, will be significantly increased causing an increase in the return required to attract equity.

Investors have legitimate expectations at the time they make their investment and Ofgem continues to acknowledge the importance of regulatory commitment. Changes to the asset lives such as those proposed by Ofgem contradict these legitimate expectations causing investors to price in additional regulatory risk, for which a higher return is required. Ofgem has suggested that the changes outlined in their RIIO proposals have been signalled for some time. A number of publications during January, following the RIIO-T1 and RIIO-GD1 consultation in December 2010, demonstrate that this signalling was not as clear as Ofgem might have hoped¹⁰. The additional detail in the December consultation document, on asset lives and cost of capital in particular, has triggered further analysis of the potential impact of the changes and the results of this analysis have caused concern.

5) Regulatory Certainty and Predictability

Ofgem have previously acknowledged the importance of regulatory commitment in the RPI-X@20 review yet the proposal for a change to electricity asset lives reverses previous regulatory decisions. Critically for its impact on regulatory certainty, predictability and transparency, Ofgem have failed to explain:

- why the criteria that influenced the original decision to adopt a 20 year asset life on post-vesting assets are no longer important;
- why the criteria for considering changes to asset lives that were set out in the January 2010 RPI-X@20 consultation are no longer important, and why Ofgem now believe it is appropriate to determine RAV asset lives with a sole focus on economic asset lives, on the basis that *“adopting this principle **balances the interests of existing and future customers** as it spreads the cost of network assets over the time they are in use.”*

However, it is far from self-evident that this single criterion is over-riding:

- In previous price controls Ofgem have recognised that other criteria need to be taken into account and are, in practice, more important;
- For the reasons that have been put forward previously by the networks (see above), the proposed change in asset life does not actually balance fairly the interests of existing and future consumers, not least because current consumers continue to benefit from artificially low charges caused by the discount between net replacement cost and RAV incorporated into the initial RAV valuation of pre-privatisation assets. This discount has been retained for the advantage of both current and future customers by the current asset lives and level of depreciation. The impact of an increase in lives would be to utilise the whole of this discount to depress charges in the short term artificially and distort the overall profile of future charges.
- Under all their scenarios CEPA have shown that network charges are set rise over the next 15 to 40 years. The proposed changes to electricity asset lives will make these increases bigger, but this additional increase has not been (and is not) justified.¹¹
- End consumer charges are much more dependent on underlying energy prices than charges for use of transmission and distribution networks¹². Consumers currently benefit from cheap electricity of which c.70% comes from gas and coal, whereas future consumers will have to pay the full cost of low-carbon electricity. Within the context provided by this backdrop of rising generation costs, intergenerational considerations themselves dictate against the proposed changes to electricity network asset lives.

¹⁰ See for example the quotations from analyst coverage included in the National Grid Transmission response to the Ofgem RIIO December consultation, 4th February 2011, pages 12 and 13.

¹¹ As CE have shown in their response to the RIIO-T1 consultation, under other scenarios of future electricity distribution investment the imbalance in future charges that would result from the proposed change in asset lives would be even greater than in CEPA's scenarios.

¹² See e.g. “Electricity and Gas Supply Market Report”, Ofgem November 2010 (Ref 146/10), and the Ofgem factsheet “Updated August 2009: Household energy bills explained - factsheet” (Ref. 81)

The failure properly to address the reasons put forward by the networks why the changes should not be made is not consistent with the Authority's powers and duties, and in particular the requirement to have regard to "*the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice.*"¹³ Clearly no case has been made that "action is needed", the proposed change is not consistent with past decisions, and because it has not been explained why past and stated criteria used in choosing a 20 year life for electricity assets have now been abandoned, it is not transparent.

It is well established that investor confidence in the regulatory framework is important and, by helping to keep the cost of capital down, is in the interest of consumers (both current and future). This confidence depends on regulatory consistency, transparency and predictability. The proposed changes to electricity asset lives have not been justified and fail to meet the requirement for consistency, transparency and predictability, and so will undermine investor confidence.

Most importantly, because the considerations that led to the original decision to use a 20 year asset life still apply, the proposed increase to these asset lives would not just be seen as a change to a particular price control parameter but would have more far-reaching and damaging consequences for the whole energy sector. It would signal a willingness on Ofgem's part to make changes to the underlying basis (i.e. the reasoning and criteria) on which important decisions are reached without objectively justifying these changes. This would undermine the concepts of regulatory commitment, transparency and predictability on which networks, investors and other stakeholders rely. As a result of these far-reaching consequences, the proposed change to electricity asset lives is not in the interests of current and future consumers.¹⁴

The recent consultation by the Department for Business Innovation and Skills (BIS) on the 'Principles for Economic Regulation' includes predictability within its proposed principles for economic regulation and states:

- *"the framework of economic regulation should provide a stable and objective environment enabling all those affected to anticipate the context for future decisions and to make long term investment decisions with confidence"*
- *the framework of economic regulation should not unreasonably unravel past decisions, and should allow efficient and necessary investments to receive a reasonable return, subject to the normal risks inherent in markets"*

In our opinion, the current proposals for electricity asset lives fail to meet this principle and would unreasonably unravel past decisions. Would-be investors in the industry will require additional return on an ongoing basis to compensate for the lack of regulatory predictability. In addition, whilst the requirement not to unravel unreasonably past decisions applies to future assets as well as existing assets, it applies particularly to the proposed change to asset lives for existing post-vesting assets, where investment has already been made on the basis of the current 20 year asset lives. In relation to these assets the proposed change should be immediately abandoned: anything less would significantly undermine the concept of regulatory commitment, both now and in the future.

¹³ See for example "Consultation on strategy for the next transmission price control – RIIO-T1 Overview paper", Ofgem, December 2010, Appendix 8, paragraph 1.10.

¹⁴ The damage to the confidence of investors and others in the regulatory framework that a change to electricity asset lives would cause would be made worse if, as has been proposed, Ofgem were to change the capitalisation of repex in gas distribution from 50% to 100%. As with electricity asset lives, the considerations that led to the current treatment of repex apply equally today, and Ofgem has not addressed the objections that have been raised by the networks nor explained why a change to the approach is now justified.

6) Transitional Arrangements

To the extent that Ofgem may wish to receive views on appropriate transitional arrangements in electricity distribution, we believe that consideration of this matter is premature. Transitional arrangements relating to a change in asset lives will only be needed if a change to asset lives is made, and for the reasons set out above (and previously explained by National Grid and others) this change has not yet been, and is not, justified. From an investor's perspective and in the interests of regulatory consistency and best practice, the proposed change to asset lives first needs to be adequately justified before Ofgem look to use transitional arrangements to manage the consequences of the change.¹⁵

7) Depreciation Profile

We agree that the current straight line depreciation profile should be retained for post-vesting electricity assets (in both distribution and transmission).

8) Other Considerations

We note that at the Ofgem RIIO Financeability Issues City Workshop on 1 February 2001, Ofgem expressed the view that "*We will put financeability on a sustainable footing – **we want to avoid storing up problems for the future***" (see slide 7). It is self-evident that spreading the recovery of investment over a longer time period has much greater potential to store up problems for the future than maintaining existing asset lives.¹⁶ Given that no case has been made that an increase in asset lives is necessary, Ofgem's wish to avoid future problems provides a further reason not to increase electricity network asset lives.

The recent consultation letter draws attention to examples where asset lives longer than 20 years have been used, in Australia, the Republic of Ireland and GB Water. For the reasons explained in our response to the December RIIO consultation, these examples do not form relevant regulatory precedents to support the change to regulatory asset lives in UK electricity that Ofgem has proposed.

9) Conclusions

As explained above, the proposed change to electricity distribution asset lives has not been, and is not, justified. Ofgem has not adequately explained the basis for its proposal, nor addressed the objections that have been raised by networks, nor demonstrated why the considerations that led to the original decision to apply a 20 year asset life to post-vesting assets in electricity (and which still apply today) can now be disregarded.

The intergenerational balance of charges is only one factor that should be taken into account in considering asset lives: even on this basis a robust case for change has not been made, but in any case there are other considerations that are at least as important. As a result the proposed change would go against the key regulatory principles of predictability, transparency and consistency. These help to underpin the concept of regulatory commitment and are essential for investor confidence, where loss of investor confidence will increase the cost of capital to the detriment of current and future consumers.

¹⁵ We provided some comments in relation to possible transition arrangements in our February 2011 response to the December 2010 RIIO Consultation.

¹⁶ As explained earlier, a switch to longer asset lives will lead to a much larger RAV building up over time. That this stores up potential problems for the future can be seen by considering the situation that is now being contemplated in gas distribution, where the future impact on charges for declining numbers of consumers (under some scenarios) could be significant, justifying reductions in asset lives and front loading of the depreciation profile today.

The proposed change would unreasonably unravel past decisions, and is contrary to good regulatory practice and the principles for economic regulation set out in the recent BIS consultation on economic regulation. This, by itself, is sufficient reason for the proposed change in electricity asset lives to be abandoned, particularly in relation to existing post-vesting assets which have been funded by networks and their investors in good faith on the basis of the current 20 year asset lives.

For these reasons presented in this letter, we strongly urge Ofgem to abandon its proposal to change the regulatory asset lives applied to electricity network assets.

Yours sincerely,

[by e mail]

Paul Whittaker
UK Director of Regulation