SP ENERGY NETWORKS

Regulation & Commercial

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Date
25 February 2011

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Dear Rachel

Consultation on Electricity Distribution Regulatory Asset Lives

I am writing in response to the open letter issued on 14 January 2011. We welcome the opportunity to comment on the issues raised.

We provided a detailed response to the recent consultation on Strategy for the Next Transmission and Gas Distribution Price Controls, including in relation to the issue of asset lives. Many of the same points made there apply here also, in particular –

- The proposal to change regulatory asset lives from 20 years to 45-55 years will have a significant impact on the network companies. Even with transitional mechanisms these radical changes will significantly impact financeability. They are certainly not, as Ofgem claims, 'NPV neutral'. We have presented evidence that shows that the resultant lengthening of duration of cash flows would require a 50 basis point increase to the cost of capital.

- Assumed regulatory asset lives of 45-55 years make little sense considering the acute uncertainties facing energy industries – not only those relating to the potential decline in the use of gas but also, in a world where energy has again become high on the political agenda, uncertainty about future changes in energy policy. The CEPA report referenced in the letter does not appear to take this sufficiently into account in its scenarios, or to fully take into account the tendency for working lives of new assets to be shorter than those that they replace or are being added to.

- Substantial investments and financing arrangements have been entered into under Ofgem's existing regime. In keeping with Better Regulation principles of stability and predictability, 'grandfathering' of existing investments should be taken into account in transitional arrangements.

Our detailed comments in relation to the proposed change to regulatory asset lives for Electricity Distribution are as follows.

1. The analysis to support the proposed change in regulatory asset lives is partial and omits a number of major relevant factors.

We are concerned at the narrow scope of analysis carried out to support the proposed increase of more than 100% in regulatory asset lives (in electricity distribution from 20 years to 45-55

years). For example, the CEPA report published in December 2010[1] focuses on scenarios for peak demand and generation and gas/electricity substitution at a **global** level. There is little or no account taken of shifts at regional or intra-regional level – for example, stranding of distribution network assets due to differential penetration of embedded generation. Also, there seems to be limited consideration of alternatives to electricity in the space heating and vehicles markets in the longer term (such as fuel cell technology) which may impact on the assumed growth of peak electricity demand.

We are highly concerned at the apparent failure to take fully into account the fluid and uncertain policy environment for energy, including electricity distribution. The CEPA report referred to does recognise a number of potential sources of uncertainty, including "policy decisions" in relation to decarbonisation. It also says that as a result ***"… it would be appropriate to review major issues impacting on depreciation life at price reviews."*** (our emphasis – this is a point not mentioned in the consultation letter). However, despite this, the report goes on to conclude that *"Peak electricity demand is expected to grow significantly in all scenarios, and so **assets are expected to be useful for their entire technical life.**"* (our emphasis). This assumes that assets are not replaced prematurely due to, for example, customer demand for new or enhanced connections, or as a result of growth in peak demand. Fault-driven replacement of switchgear and other network assets is another factor to be taken into account. Assets installed to accommodate distributed generation may also have a limited useful life, and it is in any case common for such connections to require replacement of existing transformers that are not capable of reverse power flow.

2. The very substantial financial impact on Electricity Distributors needs to be adequately recognised.

The proposals raise very important financeability issues that have not yet been addressed sufficiently. The CEPA report and the open letter refer to possible transitional arrangements, but in neither case are these dealt with in detail. It is not credible that transitional arrangements within a single 8 year price control period would suffice to address financeability issues, certainly for the 'full' (changed lives for old and new assets) option. 8 years would also not be enough for the 'split' approach (new asset lives for new assets) to work itself out.

The short term impact on allowed revenues for electricity distributors would be of the order of £500m (2007/08 prices) per annum (on the 'full' option) – or some 10% of combined allowed revenue across the 14 DNOs. This is an enormous impact, and at a time when investment requirements are likely to be as high if not higher than for the 'DPCR5' period from 2010-15.

We also do not agree that the proposed changes will be 'NPV neutral'. The move to regulatory asset lives of 45 years or more will expose both equity and debt holders to increased risk. It is hard to see why investors should be indifferent between cash flows accruing over a period of 45 years or more and those accruing over a 20 year period, particular in a sector undergoing unprecedented change in the light of environmental, security of supply and other challenges. For example there have been 3 Energy Acts since 2004 and a further Energy Bill is currently before Parliament, with more legislation to come. Quite apart from this, the available evidence from yield curve data for US corporate bonds is that investors demand a risk premium of up to 50 basis points or more for longer dated bonds.

3. The proposals raise serious issues of governance, regulatory commitment and inter-generational cost burdens.

We do not accept the argument put forward in the letter that the proposed changes to asset lives will not impact on the legitimate expectations of investors (on the grounds that Ofgem has signalled for some time that the 20-year regulatory asset life was subject to review). The DPCR4

[1] The Economic Lives of Energy Network Assets – A Report for Ofgem (Cambridge Economic Policy Associates Ltd., Sinclair Knight Merz and GL Noble Denton), December 2010.

final proposals referred to the need to maintain 'broadly stable financial profiles' as one of the reasons for switching to a 20 year life for post-vesting assets. Investors would have been entitled to assume that any subsequent changes to asset lives would also have regard to the need for stability in financial profiles. It does not follow that investors should now view a step change of more than 100% to regulatory asset lives with equanimity.

The argument for a strong consumer interest in the change also does not seem strong. Firstly, Ofgem has a duty to balance the interests of existing and future consumers and it is not clear that existing consumers, already benefiting from the discount between net replacement cost and RAV incorporated into initial RAV valuations of pre-privatisation assets, have a strong case for further assistance at the expense of future consumers. Secondly, the modelling carried out by CEPA et al in their paper on asset lives does not seem to suggest a great consumer benefit from the proposed changes.

We have made substantial investments and financing arrangements have been entered into under Ofgem's existing regime. We believe that changes to regulated asset lives that would unravel the basis for these are inconsistent with Better Regulation principles of stability and predictability and will have a damaging effect upon prospective investors' assessment of the energy networks sector.

4. Transitional Arrangements have not yet been adequately addressed

Ofgem accepts that there is a case for transitional arrangements to mitigate perceptions of increased regulatory risk. However, it has suggested that any transitional arrangements should work themselves out within the next price control period. At the same time, it has acknowledged that the 'split' approach – in which the new asset lives would only apply to future investment – is a possible approach (and one which would clearly not work itself out in one price control period).

In our view, any transitional arrangements should start from the principles underlying a split approach – in other words, the desirability of 'grandfathering' regulatory arrangements in respect of investments which have been undertaken under an existing regime. A robust argument for adopting such an approach is indeed offered by DECC in its recent consultation on electricity market reform.

'Grandfathering: the Government recognises the importance of honouring commitments given to provide generators with a particular level of support, as part of maintaining investor confidence'.[2]

Thus, generating plant which has been built on the basis of the Renewables Obligation (and, indeed, plant which is being planned on this basis but not yet built) will continue to operate under the existing regime.

Similarly, in discussing the introduction of an Emission Performance Standard (EPS), DECC states:

'One of the unavoidable risks in the energy sector is regulatory: at any point during the operating life of a power station, Government may change the regulatory environment and undermine the economics of a power station, forcing early closure with implications for the investor's finances. However investors will gauge the overall regulatory risk in the UK, based on Government behaviour and a series of discrete, individual decisions. Where investors perceive actions are taken against one set of generators, they will become increasingly nervous and might choose not to make new investments in the UK because of their perceptions of the regulatory risk. For example, decisions taken by the Spanish Government over summer 2010 to

[2] Consultation on Electricity Market Reform, page 122, DECC, December 2010.

retrospectively reduce levels of renewable subsidies has affected levels of investor confidence in Spain and indeed across other European countries.

Another way of helping to ensure investor confidence in the UK energy sector would be to apply the principle of grandfathering, which is widely used in regulatory regimes, including the Renewables Obligation. In its simplest form, the principle of grandfathering, when applied to an EPS would mean that the level of the EPS in place at the point that a power station is consented remains the level which is relevant for the economic life of that power station, i.e. if Government decided to lower the level in the future, say to reflect advances in CCS technology, the EPS would only be at the lower level for plant consented after date of that decision. Without such protection in place, the regulatory risk around investing in new fossil-fuel power stations might prevent any new flexible plant being built, creating a risk to security of supply. The Government's initial view is, therefore, that the EPS be grandfathered, for a period linked to the period of time investors would expect to see a return on their capital investment.' [3]

We are strongly of the view that similar considerations should be applied in the case of regulatory asset lives for electricity distribution.

In conclusion, we are highly concerned at the proposed changes to regulatory asset lives set out in the open letter. Particularly under the 'full' option, these would amount to unraveling the regulatory treatment of investment carried out under previous price control arrangements, and have a dramatic effect on the financeability of companies. However, we welcome Ofgem's recognition of the need for suitable transitional arrangements in the light of concerns from stakeholders, and we look forward to further discussions to develop these further. We will be bringing forward our proposed solution as part of our RIIO T1 business plan submission later in 2011.

Please contact me if you would like to discuss any of the above points.

I am copying this letter to Peter Trafford.

Yours sincerely

Scott Mathieson
Regulation and Commercial Director

cc. Peter Trafford, Ofgem

[3] Op.cit.