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Dear Tom,

RIIO-ED1: Informal consultation on fast-track licence drafting – Charge Restriction Conditions (Part 1)

Thank you for the opportunity to respond to Ofgem's informal consultation on the fast-track licence drafting for WPD. We have not performed a detailed review of the terms and formulae within the conditions however we would like to draw your attention to a few issues we have identified.

- The **PU** terms contained in appendix 1 of CRC 2A (Restriction of Allowed Distribution Network Revenue) are slightly different to the figures contained in the published Fast Track Draft Determination Financial Model. The differences are small (<£0.5m/yr per licensee) but we are not clear why there should be any differences.
- Assuming there is a reasonable explanation for the above variances, the **PU** terms in the licence have not taken account of the latest 10 year average cost of debt (2.72% instead of 2.92%) and as such the PU terms are overstated. The PU terms that are entered into the licence (and indeed the financial model that determines them) should take account of the latest available information on the cost of debt. To knowingly set revenues using a high and out of date cost of debt unnecessarily imposes a financing cost on consumers. This is inappropriate since consumers have a higher financing cost than networks and so will not be NPV neutral from such upfront funding.
- We also see significant risk of upfront funding with regards to the assumptions being used for business rates for WPD (the **RBE** term in appendix 2 of CRC 2B, Calculation of Allowed Pass-Through Items). As we have highlighted in previous responses, we can see a large increase in business rates for WPD being assumed from 2017/18 and increasing yet further to a level in 2019/20 which is £44m/yr higher than the start of the period – a c. 50% increase over the period.

Given the uncertainty surrounding the new level of business rates following the next ratings revaluation in 2017, we believe that it is more appropriate to hold these allowances flat as has been assumed by the vast majority of all other networks (both electricity and gas distribution and transmission networks). As well as the obvious concern again surrounding the potential for an unnecessary financing cost on consumers, we also note that permitting such large increases in such uncertain pass through costs will negate the policy intent contained in paragraph 2B.13:

“2B.13 If, after reviewing the licensee’s engagement with the relevant valuation agency with respect to a particular revaluation, the Authority considers that the licensee has not used its best endeavours to minimise the amount of the Business Rates to which it is liable, the Authority may, subject to paragraphs 2B.14 and 2B.15, by Notice to the licensee specify that any positive value for RB (and only a positive value) for one or more Regulatory Years derived under the formula set out in paragraph 2B.8 is to be changed to a different value.”

We support the policy intent of this licence clause however we consider that it requires a flat forecast of business rates to deliver the intent behind it. If a DNO has factored in a 50% increase in business rates in its base assumption as WPD has done, then the above clause can only have any impact if the revaluation results in a greater than 50% increase in rates payable, regardless of whether or not a DNO has had any engagement with the valuation agency. This is because the substitute value proposed by the Authority can only be positive i.e. can only occur where actual business rates are higher than assumed base assumption business rates. Indeed this could create a perverse incentive for DNOs to over forecast business rates as this would remove or reduce the risk of any ‘penalty’ for non-engagement. We would ask Ofgem to review the WPD assumed business rates prior to setting allowed revenues to ensure that its policy intention in this area is protected and to ensure that consumers do not unnecessarily incur financing costs.

We hope you find our comments helpful. Please do not hesitate to contact me if you have any questions.

Yours sincerely,

Andy Manning
Head of Network Regulation, Forecasting and Settlements