

25 January 2008

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Dear Rhiannon

### **Setting price limits for 2010-2015: Framework and approach**

I am writing on behalf of members of the Energy Networks Association (ENA)<sup>1</sup> in connection with your consultation paper. We welcome the opportunity to comment on Ofwat's proposed approach to the next price review for the water sector. ENA believes a long term perspective for assessing the investment requirements for infrastructure industries with long-lived assets is appropriate and supports the steps that Ofwat has taken to embed the current review in a longer term and wider context.

The electricity distribution industry is also engaged in a price review process with similar timescales to that of the water sector and we recognise that there are high-level themes that are relevant to the price review processes in both industries. Similarly, although the gas distribution price review has just been completed, there are relevant considerations from the outcome of that review.

Against this background, we have three main comments to make, which we set out in turn, followed by some more detailed points arising from the consultation. Our main comments relate to the cost of capital; to the development of incentives; and to progress on the sustainability agenda.

### **Cost of Capital**

The cost of capital is clearly a very significant element in setting the price control for regulated infrastructure companies. It is vital, in our view, that an adequate overall cost of capital is determined to protect the incentives to invest in critical national infrastructure. We believe that if the cost of capital is adequate, there should be no need to consider any specific "financeability" adjustments for particular companies, which are unfair and undermine the credibility of the general methodology adopted.

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<sup>1</sup> CE Electric UK, Central Networks, EDF Energy, National Grid, Scottish & Southern Energy, Scottish Power, Electricity North West.

We support the basic framework of the “CAPM” methodology for setting the cost of capital, when used pragmatically. We note that other models can provide a useful sense check for this familiar approach to determining the cost of capital. On some of the particular points raised:

- i) On cost of debt, we do not believe that, if interest rates fall in the shorter term, the cost of debt for all affected businesses also falls. Infrastructure businesses should be looking to fund on a long term basis (reflecting the nature of their underlying asset base) to avoid unnecessary re-financing risk. We also doubt that the current market appetite for index-linked debt will last as we believe it has been based on an arbitrage opportunity acted upon by a limited sector of the market. We do not therefore believe that there should be a core assumption that infrastructure companies will be able to access such debt going forward.
- ii) On cost of equity, we believe it is always useful to use the dividend growth model as a sense check against a CAPM led approach and to avoid undue weight being given to short term market fluctuations.
- iii) On the proposal to index a component of cost of capital to a market benchmark, we believe that this would be very complex and that there is no proven need to change the historic approach to setting a value for this parameter for the duration of a price control period. In fact, due to the increased level of subjectivity that such an approach would bring, we doubt whether a workable, sustainable and widely acceptable methodology could be devised to do this.

Finally, we would refute any suggestion, which appears to be implied in Ofwat’s discussion of the CEPA report in the document PR09/03, that there is any “headroom” in the cost of capital set by economic regulators using the CAPM and other methodologies.

## **Incentives**

The energy infrastructure industries, like water, have seen the development of the original “RPI-X” approach to price controls developed to encompass further, more detailed incentives in successive price control periods. In particular, both gas and electricity distribution have already adopted the “menu regulation” approach to the control of capital investment, which Ofwat is now proposing for the water sector. The ENA considers that this incentive has benefits for both companies and customers.

Generally, we believe that a structure of incentives, which allows companies the possibility of out-performing targets and thereby increasing their return relative to central expectations (as well as suffering a corresponding penalty if targets are not met), is a constructive means of incentivising companies to focus on particular desired outputs. However, we would caution that an incentive structure that has a greater scope for penalty than for reward will inevitably lead, not only to more costs and complexity for companies in adjusting to and reporting on the new incentive framework, but also to increased financial risks. This would inevitably feed through to investor perceptions and thereby to the cost of capital.

We are not familiar enough with the current package of incentives on water companies to assess the overall balance of upside and downside that it represents. However, there is one aspect of the proposed implementation of the menu regulation approach discussed in the related document PR09/02 where Ofwat suggests a less favourable approach than that used by Ofgem in the implementation of this incentive in energy. This relates to the breakeven point within the algebra of the incentive. Ofwat proposes that this is set where a company forecast is at 100% of the agreed baseline, whereas Ofgem set this 5-10% higher. In our view, it is appropriate to recognise the inevitable uncertainties in assessing the baseline expenditure by allowing some headroom in this parameter.

## The Sustainability Agenda

ENA recognises the growing importance of the sustainability agenda in setting parameters for infrastructure companies in the periodic price reviews. We would support infrastructure companies being incentivised to attain outcomes compatible with the sustainability agenda insofar as they can control these outcomes. In the case of water, we cannot offer a view on the scope for reducing the carbon footprints of companies and for reliably assessing improvements in this measure, but we note the emphasis on this aspect of Ofwat's proposed approach to the next price control framework.

Our comments on the overall balance of incentives are relevant also to any specific targets that Ofwat may consider setting for carbon footprint measurements. We would advocate that any such additional measures and incentives are introduced in the least bureaucratic manner possible. In this respect, we suggest that market mechanisms for achieving desired outcomes are considered where feasible. We believe that these would generally allow companies greater freedom to determine the cost effectiveness of different solutions than alternative approaches and thus that desired outcomes would be achieved at overall least cost across the industry.

### Other Points

#### Notified Items

At section 2.3.1 of the consultation, Ofwat discusses the current set of "notified items", which are headings under which companies can apply for any material additional costs occurring during the price control period to be logged up. The headings correspond to areas where it is recognised that there is significant uncertainty on outturn cost levels. This approach has been adopted in electricity and gas in recent price control settlements and we believe it is a useful mechanism for addressing particular areas of uncertainty.

We are therefore concerned by Ofwat's comment that it sees no need to continue with any notified items in the next price review period. In particular, while many of the notified items are specific to the water industry, uncertainty in the quantum of costs that could occur for lane rental/traffic management under the Traffic Management Act 2004 and related legislation also affect the gas and electricity distribution companies. In our view, material uncertainties remain on infrastructure companies' exposure to Local Authority charges under this legislation and as such, this notified item should remain.

We also believe there may be a case for an additional notified item relating to cost uncertainties around the potential withdrawal of BT's legacy services that allow dedicated signalling circuits as BT moves towards deployment of its new "next generation" core communications infrastructure network – the so-called "21<sup>st</sup> Century network". This issue affects energy network protection signalling circuits and we understand that there could be a similar issue for water companies.

#### Accounting Separation

Section 1.3.1 of the document discusses competition and proposes the development of greater accounting separation between different business areas that the water companies are engaged in. We would support increased transparency and separation of costs, especially between the areas of a water company's activities that can be categorised as monopoly infrastructure provision and those where competition is possible – most notably the final supply to customers. The supply activity has been legally separated in the case of the energy markets and with the increasing emphasis on competition in the water industry, we believe that a requirement for increased accounting separation is a proportionate regulatory response. This requirement should, in our view, enable a more robust platform for competition to develop (in terms of allowing transparency and non-discrimination in

relevant charges to be monitored) than would be the case if monopoly activity costs could not be readily ring-fenced from competitive or potentially competitive areas of business.

## Conclusion

In conclusion, we would support the objectives that Ofwat has set for the review of price controls in the water industry. In particular, we welcome the emphasis on the longer term framework, the developing agenda on global priorities such as sustainability, the continuing development of a balanced incentive framework and the promotion of competition where feasible. Our comments above are restricted to those where we believe there are parallels with the price regulation of energy infrastructure and we hope that they are helpful as Ofwat develops its approach to the implementation of the next price review.

Yours sincerely

A handwritten signature in black ink that reads "Andy". The signature is written in a cursive style and is positioned above a horizontal line that extends to the right.

Andy Phelps  
Head of Regulation