Peter Kettle (1/10/02)

REVIEW OF ELECTRICITY DBs PAST AND PROJECTED CAPEX AND OPEX

INPUT TO FINALISING THE BRIEF

This response to the Consultation Paper's invitation for comments on how prudency and efficiency should be assessed, in the context of the Draft Brief's proposals and issues raised, has been prepared by Peter Kettle and Associates who have a specialist interest in this area.

PKA's comments and suggestions are as follows:-

A. Prudency

1. **Criteria and application:** The draft notes that, in addition to the quality of a DB's planning and evaluation procedures, prudency of past expenditure should be examined in relation to the significant drivers and whether regulatory service standards have actually been met. Suggest the standards test is used primarily as an after the event check on whether **under-spending has occurred** in these areas - irrespective of circumstances when the spending decisions were made - whereas the rest of this work should be directed to examining whether decisions (on all types of expenditure) were **soundly-based at the time they were made**. The latter would be divided into (i) major expenditures and (ii) all the rest, since we believe they should be treated differently.

2. The **"major"** expenditure category requires a focus on whether the case was convincingly made out: suggest the test applies the level of sophistication and rigour that a competent Board would expect to be contained in "business cases" submitted to senior management or itself. For the **remainder of the expenditures,** involving decisions taken at a lower level but likely to have absorbed a sizeable proportion of the total spend, the review should rely on an assessment of the quality of the planning and decision process followed. We consider that it should not delve into the specifics of the case developed for any particular expenditures unless serious faults are found in the procedures themselves. Given the outcomes, an eye should be keenly on whether excessive commitments were made (given the circumstances at the time).

3. **Remuneration of Prudent Spending Above the Original Forecasts:** Not mentioned is made in the Draft as to whether any retrospective interest and depreciation would be allowed on such capex – ie be applied to the current price control period in addition to 2003/04 onward. Have not found a clear precedent for this, and retrospective remuneration would go against some basic general principles of an incentive-based regulatory regime. More specifically, consumers would never be advantaged, in that optimistic forecasts of expenditure needs would mean they part with more than is necessary and pessimistic forecasts would mean (after the event) compensation to a DB.

The regulator may then feel impelled to change established policy and make provision only for below "most likely" estimates at price resets and rely more on ex post compensation to DBs in order to protect consumer interests.

B. Efficiency

4. Strongly support the **separation** of evaluation of past and projected capex **into that required specifically to uphold regulatory service standards and other sums** (Draft, p2). We consider this to be consistent with the way that a commercially-driven, independently regulated, business should assess and justify its network expenditure – treating regulatory-related amounts as an increment on the amount which is desirable in terms of its own commercial interests. The purely "commercial" side of expenditure is concerned only with the least cost timing, amount and form of renewals, capacity enlargement and extensions needed to sustain the network. This projected commercial expenditure requirement has implications in particular for the levels of reliability and quality of supply; but these implied service levels may still fall substantially short of the standards set. Hence, the typical need for a regulatory increment on top of the **prior** commercial estimates. Usually, the commercial component can be expected to comprise the majority of the total requirement.

5. So there would be two basic categories – commercial capex and a standards-related increment, with the former sub-divided into growth and renewals related. Also, would be useful for rounding out the statement, and for considering if best options have been taken, to sub-divide the standards increment into type of investment – extra renewals, upgrading of assets, and whatever.

   The **chief merit** of this way of approaching the review and the justification for past spending and a forward funding claim is that it supports the basic division of functions and responsibilities between company and regulator – to mutual advantage – and it puts economic regulation and debate into its proper context.

6. Suggest the Draft stipulates that the "growth category" of capex is to be divided into expenditure to reflect the distinct reasons of:

   (a) accommodating new connections (inclusive of directly related required augmentation of local networks), and
   (b) elimination of upstream capacity constraints – as caused by general demand increases and/or multiple sources of additional connections.

7. **Capex/opex trade-offs**: Choices made between more and less capital-intensive solutions to renewals (their timing and form) and capacity enlargements (their form), in particular, lie at the heart of testing whether projected commercial and regulatory capex does represent least cost solutions or responses. Therefore consider that the references in the Draft to taking capex/opex trade-offs into account might be expanded on.