CER/05/141

Airtricity Response to CER/05/117

Consultation on ESB DSO Allowed Revenue

Introduction

ESB DSO revenue is a major fixed-cost overhead on Suppliers is a significant component of retail tariffs, so a revenue review that bears down on this cost is to be welcomed. However we believe that the proposed regulatory settlement through to 2010 is overly generous to the DSO and does not adequately balance the interests of customers who have faced significant increases in their wires charges since the low point of 2003 – mid-way through the initial Distribution Price Review. The Consultation contains a great deal of background information on the Commission's proposals, but it is not always clear why some decisions have been made, such as when particular values have been selected from a range of possible choices.

Our comments on the Consultation address the four main areas of asset base, asset life, cost of capital and corporate overheads, before turning to some of the points of detail. Our starting point is that the Consultation clearly shows that ESB DSO is a high-cost operator in comparison with its benchmark and we believe that the acknowledged operational inefficiencies of 3% to 11% should be eliminated within the first two years of the new price control. We support the Commission's proposal to limit ESB DSO's Network capex to a level that is more consistent with its benchmark, but consider that the four areas listed above can realistically be revised to deliver further savings.

Regulatory framework

Regulatory Asset Base

With a significant rate-of-return element in the analysis, establishing the Regulatory Asset Base is critical. The Commission has indicated that in the past there may have been an element of double counting as a result of assets not being removed from the RAB when they were replaced and that, for the next five years, it will not allow for marginal/unnecessary investment. This suggests that ESB DSO is not immune from the desire to inflate allowable revenue by the addition of non-essential investment to its asset base. There are two questions on how the baseline RAB has been established; to what extent has the Network been reviewed for under-utilisation and how has asset valuation been carried out?

Because the Network suffered from extended under-investment for many years, it is likely that a number of sub-optimal investments were made on the basis of minimum capital spend rather than on the basis of working towards an optimal system. If the RAB baseline is historically over-capitalised and does not therefore reflect an efficient system, then all subsequent adjustments are merely building on a weak foundation and provide little real incentive to work towards optimisation. Airtricity believes that in view of the scale of asset base required by ESB DSO and the impact of

any valuation errors on retail tariffs, that an independent system design expert should be retained to develop a reference Network design for Ireland, to be used as the basis for future RAB valuations. Revenue earned on this basis would provide a powerful incentive to ESB DSO to design the real system towards an optimal one.

The second question relates to the clarity of the Commission's proposed Replacement Cost basis of asset valuation, as it is not clear from Section 5.1.2 whether "Replacement Cost basis" refers to a decision to use MEA, Indexed Acquisition Cost, or a combination of the two. All regulatory approaches to establishing a RAB have drawbacks and a degree of subjectivity, but the balance of findings in the regulatory literature indicates that utility asset bases are more likely to be over-capitalised than not, when used as the basis of income regulation.

Operational Expenditure

The graph of uncontrollable opex in Section 8.5 shows the significant impact of a relatively modest increase in asset life, from 40 to 45 years. Table 6.1 shows that some classes of asset can have even longer lives. We therefore believe that instead of using a single value for asset life, ESB DSO's assets should be grouped on the basis of reasonable expectation of similar life expectancy and depreciated accordingly. Switchgear and some transformers appear to have a significantly longer mean life expectancy than 45 years.

WACC

The third financial driver that includes a degree of subjectivity is the choice of WACC. ESB DSO is a regulated monopoly that enjoys a guaranteed return on approved assets and an interest-bearing "K" factor in the event that the allowed revenue is not obtained. It is difficult to imagine a lower risk operation, yet the Commission is proposing a WACC that is set at the same level as the proposed ESB PES WACC, which operates in a competitive market and can (theoretically) lose a significant portion of its customer base. We do not understand why, when the analysis has resulted in a range of values for interests rates, the Commission has always selected a value that is above the average. This implies that ESB DSO carries above average risk compared with its comparators and we do not believe this to be true.

In setting the risk-free rate, after a discussion on the possible range of values set out in Table 5.4, the Commission

"notes that many commentators view this rate as likely to increase in the future"

The choice of bonds used in the analysis was made with liquidity as a specific criterion of selection. Liquidity in a financial instrument means that the market consensus on future factors that influence its value is already built into the price. When the market perceives a different set of circumstances, the price will change. In the long run any forecast of price movement up or down will undoubtedly be fulfilled and without any timescale as to when these commentators' view on upward price movement is supposed to happen, there is no reason to apply a modification factor to current bond prices. Rather than selecting a risk-free rate that is 70% of the difference between the top and bottom rates defined, on the basis of the views of "some commentators", we believe that it is

equally valid to select a value that represents 30% of the difference. We therefore believe that the risk-free rate should be set at 2.24%.

Similarly, for ERP the Commission has chosen a rate that is 90% of the average of the highest values in Table 5.8. Again this is

"to take into account the historically low values of the ERP observed currently"

There is no indication of when the current rates are expected to move from these current levels. A similar argument could be made for a future increase in inflation because current levels are low in comparison with those of the 1970s. Table 5.7 shows that ERP values at the lower end of the range relate to GB investor-owned businesses and suggest that choice of ERP is related to the Regulatory Authority and possibly market sentiment within the jurisdiction, as much as to the riskiness or otherwise of the businesses. Considering the level of financial guarantee available from a State-owned monopoly owner and operator of an essential service, we believe that the correct level of ERP should be 90% of the average of the minimum values in Table 5.8; the appropriate ERP being 2.86%

In relation to Beta, the Commission has again chosen a value

"reflecting the potential current under-valuation of Beta"

Even accepting that 0.8 is the correct value for this factor, Airtricity believes that the correct WACC for ESB DSO is 4.53%

corporate overheads

"The operating costs of the international companies used to benchmark the operating costs of each of the separated businesses include all relevant management and administration costs for each business"

The Commission's analysis shows that ESB is a high-cost operator, although steps taken in the current review to disallow certain costs is welcome in bringing the DSO more into line with the international benchmark. We support the Commission's focus on the elimination of all non-essential Corporate overhead from being recovered through the regulated businesses. However we believe that activities that are currently Corporate, but relate to each of these businesses, should be moved into each business and included in the general opex cost reduction incentive. Although the amount of money involved is almost trivial in comparison with other aspects of the business, it nevertheless amounts to €46.9m over the five years and ESB DSO needs to be given every incentive to reduce this, to ensure that final customers receive the most cost-effective service.

Detail issues

tariff disaggregation

ESB DSO undertakes many activities in addition to the distribution of electricity. In the context of market opening and in relation to other initiatives, the suggestion is generally made that any additional cost can be collected through DUoS. Whilst this may be appropriate in many cases, Airtricity is concerned that DUoS charges are becoming a general cost collection mechanism and that transparency in the magnitude of costs and their allocation across tariffs is opaque. For example, it is not clear whether data collection is charged on a per-register basis, or if different levels of charge are applied to domestic and commercial customers. Will MOIP costs be levied on a per-customer basis, or as a component of the kWh charge? Airtricity believes it is essential that published DUoS charges should be disaggregated into separate charges for:

- distribution
- meter operator
- data collection
- MOIP, and
- other

While this means that the current structure of the DUoS tariff will have to change, the approach is essential to provide clarity on how customers' money is being spent. It is also consistent with international practice.

DUoS tariffs

Although not specifically part of this Consultation, we believe that published DUoS charges should be based on the marginal cost approach recommended in earlier work by the Commission.

Opex

We support the Commission's objective of reducing ESB DSO opex levels to those of efficient comparable companies by 2010. In particular we support the proposal to reduce ESB DSO's proposed MOIP and depreciation figures.

Appendix E shows the calculation of RAB depreciation, but it is not clear whether network renewal is brought into the asset base. As depreciation is charged on a current cost basis, any asset replacement maintains the value of the RAB, rather than adding to it. The Commission has allowed additional capex to be brought into the asset base if assets are found to have deteriorated unexpectedly, but we do not believe it is correct to treat expenditure of this sort in this way. As ESB DSO moves towards condition-based replacement, rather than time-based replacement, some assets will be found to last longer than expected and others to last for a shorter time. Airtricity believes that the only assets that should be brought into the RAB are those that increase the value of the Network, by increasing its reach or the marginal expenditure on increasing its capacity or reliability.

Airtricity's experience is that when it is possible to make a direct comparison between ESB charges for connections and offers from private contractors, ESB charges can be up to double the cost of the cheaper quote. We do not therefore totally accept that

"the DSO's load related capex is higher than the majority of the companies benchmarked reflecting the high level of investment to meet load growth"

Airtricity believes that ESB DSO's procurement of new assets should also be subject to audit and benchmarked against the provision of similar assets by other DSO's.

The Commission notes that much of the apparent decrease in controllable opex seen in the first Distribution Price Control period has been due to load growth. We look forward to seeing more significant reductions over the next five years, as the Commission's lower allowed opex feeds through to lower customer charges.

Meter Reading

Airtricity's experience is that the current target of four actual meter readings per annum is far from being achieved. It is not only remote, unmanned sites that are not being read, but urban, commercial premises. If a new target of six readings per year is to be implemented, with a commensurate increase in cost to Suppliers and hence to customers, we would want to see some significant penalties imposed on ESB DSO for failure to deliver on this important aspect of customer service. In particular, it is essential that this activity is separately identified in DUoS tariffs and that Suppliers should be able to dispute payment where the service is not being delivered over an extended period.

Summary & conclusion

Airtricity is concerned that the baseline RAB may incorporate past inefficient Network design and thus undermine the value of the revenue control process going forward. In view of the major impact of RAB on customer charges, we believe it is appropriate for the RAB to be benchmarked against a reference Network design for Ireland and that the cost of obtaining such a design is an appropriate investment in delivering public confidence in the cost of the ESB DSO monopoly.

As the ESB DSO is a public, almost risk-free monopoly, we do not accept that the high WACC proposed by the Commission, the same as that applied to ESB PES, is appropriate to the nature of the ESB DSO business and if unchanged will unnecessarily increase charges to customers.

The Consultation highlights the value of applying the most appropriate asset lives and we believe this process should be carried further, through the inclusion of appropriate additional asset categories for assets with expected lives longer than 45 years.

With such a diverse range of activities included in its cost, it is essential for transparency, that each ESB DSO business activity is separately identified in the DUoS tariff. In the light of previous work by the Commission, we also expect that the wires charges will be based on the marginal cost approach analysis previously undertaken.