

DNO Working Group – Uncertainty Under Price Controls

Meeting 1 – Summary (v2)

30 August 2002

Attendees: Cemil Altin (Ofgem) Adrienne Monroe (Ofgem)
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 Paul Delamare (LPN)

This note was amended as a result of discussion at the 7 October meeting.

This working group on uncertainty under price controls focused on three main areas.

1. Areas of Uncertainty
2. Impact of Uncertainty
3. Mechanisms for Dealing with Uncertainty

Areas of Uncertainty

There are four main areas of uncertainty under price controls

1. External uncertainty
2. Uncertainty arising from the regulatory process
3. Uncertainty arising due to industry or firm specific factors
4. Uncertainties outside the control of the regulator

We looked at each of these in order and then listed a number of 'other' possible uncertainties.

1. External uncertainty

- Taxation
 - Changes to rate or changes in tax law
- Electricity Supply Regulations
- Government Intervention / Objectives
 - Regulatory Independence e.g. Railtrack
- Lane Rentals
- Environmental Issues
 - Energy Efficiency Measures (Demand Side)
 - 2010 Targets For Renewables / CHP
- Distributed Generation / Energy White Paper
- Congestion Charging
- Health and Safety Legislation e.g. Electro Magnetic Fields

2. Uncertainty arising from the regulatory process

- Principles of the price controls

- Consistency over time
 - Cost recovery – investment can be over a longer period than the price controls last
 - At price controls e.g. benchmarking (and different methods of benchmarking)
- Increase in Performance Based Regulation (differences in upside risk)
 - IIP Type Mechanisms
- Information Asymmetry
 - Firms have more information than the regulator - this can lead to the possibility of regulatory uncertainty as the regulator may make an uninformed decision
- Change in Consistency of Regulatory Approach – Across Energy and Utilities
 - Cost of Capital Transparency – Method
 - Mergers
 - Dealing with Uncertainty

3. Uncertainty arising due to industry or firm specific factors

- Demand
 - Scale / Location (“churn”/ utilisation) – Demand Growth can occur industry wide or it can occur at different rates in different regions.
 - Impact Generation /DCHP
- Customers’ Requirements
 - Major users, End users, D. Generators
- Suppliers
 - Requirements
 - Supplier Failure
- Asset Risk – Different network approaches e.g. running an asset into the ground may be the most economic option, but is it the option most beneficial to consumers?
- Utilisation of assets – (Driven by demand)
- Availability of Finance
- Environmental Issues
 - Extremities of Weather (National / Regional)
 - Would government extend energy efficiency measures to DNOs
- Distributed generation

4. Uncertainties outside the control of the regulator

- Increased terrorist threat – insurance → costs increase
- Access rights for renewables – European directive
- Change in the Regulator → with a view to Callum McCarthy’s departure
- Innovation
 - Shortage of engineers – regional?
 - Encourage R&D

- Competition in Connections, Supply and Metering
 - Adoption

- Inset
- Independent Electricity Distributors
- Data Aggregation – Particularly if losses incentives increases.
 - GSP Account
 - Billing / Revenue

Facilitating Competition (Costs!)

5. Uncertain Uncertainties

- War
- Unexpected Government Change (U.K. / European / American)

Impact of Uncertainty

This section deals with the issues uncertainty raises and the impact this may have.

1. Costs

- A significant number of the areas of uncertainty could have cost implications for the industry. For example, an increase in distributed generation will require higher investment and operating costs.

2. Financing Issues – Although a subset of costs, uncertainty can have a specific impact on financing issues including:-

- Impact of Uncertainty on Revenue / Cash Flow
- Failure of Suppliers
 - Gearing and Credit Rating Effected
 - Share Price Effected
 - Enterprise Value Reduced
- Availability of Finance – can still be acquired but at a higher price

3. Decision making

- Reacting to uncertainty distorts the decision making process
 - Reliance on Short Termism - focusing on price control period instead of long term
 - Reduces Willingness to Invest, particularly if coupled with an increase in the cost of capital.

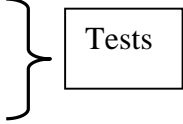
4. Compliance

- Meeting Regulatory / Other Requirements – can be harder to achieve if the company is exposed to significant uncertainty.

5. Efficiency – If there is significant uncertainty companies may take contingency steps, which may increase costs above the efficient level. This will also have an impact on the decision making process (point 2 above).

Mechanisms for Dealing With Uncertainty

In order of the amount of risk the company is exposed to

1. Pass Through – Straight to Consumer (Actual Costs)
 - Ex post – where cost is subsequently incurred then passed through
 - Ex ante – Where cost can be identified in advance
2. Conditional Pass Through
 - Bad Debts
 - Lane Rental
 - Efficiency Process
 - Behavioural Process
3. Interim Determinations
 - Materiality Test (Efficiency?)
 - Enforceable Re-opener
 - Comfort Letters
 - Different Forms
 - Legal Standing of comfort letters / specific licence conditions
4. Error Correction Mechanisms / Revenue Drivers
 - Caps / Collars
5. Logging Up
 - Efficiency Test
 - Variability Test
6. Contingency Allowance – Where specific allowances are made for uncertainty
 - Set by regulator in advance on estimate of likely costs
 - One Offs - e.g. Insurance Allowance / Ship Wreck Clause (Ofwat)
 - SO type of risk sharing mechanism
7. Unbundled Risk
 - Treated Differently e.g. CAA / Ofreg
 - e.g. separate price control for riskier projects allowing you to assess risk between projects.
8. All risks reflected in the cost of capital – no allowances / adjustments made

Mechanisms for Dealing With Other Uncertainty

Regulatory Uncertainty

- Lengthening Review Period
 - Transparency, appeals etc

- Regulatory Impact Assessments
- Increasing the Scope of Licence Conditions – This could create certainty about regulatory decisions
- Documentation and Transparency in Regulatory Process
 - Aiming for Consistency of Approach
- Better Consultation / Expectation / Decision Making
- Detailed Regulatory Framework - e.g. Outputs – identifying what companies expected to deliver
 - Compliance

Non – Regulatory Uncertainty

- Internal Business Solutions
 - Asset Risk Management
 - Risk Logs