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Dear Cemil

DEVELOPING NETWORK MONOPOLY PRICE CONTROLS

I am pleased to have the opportunity to comment on the issues raised by your initial consultation on developing price controls.

We are pleased with the way you have begun work on this project and welcome the open and collaborative style of working that is emerging. We agree with Ofgem that there is much that can be achieved through co-operative action designed to improve the framework of regulation for the benefit of both customers and licensees.

I will set out our comments in the sequence used in the consultation paper.

1 Introduction

We support the objectives for the project set out in para 1.18, and agree with the structure of work suggested in 1.19. However we feel it would be helpful if the outcome of the internal review described in 1.20 were also published. This would enable other parties to benefit from any lessons learned.

2 Approach to Undertaking Price Control Reviews

Setting the Price Control – We agree that the categories defined in para 2.2 represent the costs that need to be covered by the Licensees' income. However it does not automatically follow that allowed revenue should be constructed in this way. For example it is not clear how incentives would be introduced to encourage new behaviour traits, such as may be needed to change performance standards or to support 'network transformation' reflecting wider Government Environmental policy.

Publication of Information – We support your aim of improved transparency. This should be assisted by the development of Regulatory Accounts and the information requirements of IIP. As you know, we would also like to see open discussion on the financial models to be used by Ofgem, and we support the idea of an 'agreed model' that would be available for all parties.

Objectives, Principles and Issues – We agree that the review objectives should be derived from statutory duties and obligations of the regulator and Licensees, but that regard for other influences is also important. There is always likely to be a need to reconcile potential conflicts between these objectives and it would help if the process to resolve such tensions were also set out.

The principles you identify in 2.13 are important but could be supplemented with others related to the process of the review. The Better Regulation Task Force model should be adopted. The methodology for assessment of features of the control should make clear how the interaction between service performance (outcomes) and cost (inputs) will be incorporated.

Recent experience has demonstrated the value of workshops to identify key issues for the review process. We would expect Ofgem to confirm the use of such fora for the development of issues. This could be added to the rather less explicit commitment to consult in para 2.12.

Specifying Outputs – It is important that outputs, and their value to customers, are given sufficient consideration early in the review process. This should ensure that the plans used to derive cost estimates reflect the reasonable requirements of customers. Again the need for compromise between price and quality will become apparent and Ofgem should seek to define the techniques that will be employed in settling on an appropriate balance.

Incentive Framework – Incentives will be needed to both maintain standards and to encourage shifts in behaviour. It will always be challenging to secure a package of measures that meets these requirements, and it will be important to establish, early in any review, the relative importance of the different goals that can be identified.

Financial Modelling – We believe it is appropriate to model financial performance over a period considerably longer than the five years for which a price control is normally set. As a minimum, the impact of investment and opex trends on prices and financial indicators should be modelled over a ten-year period.

Process Review – We welcome the suggestion that Ofgem will initiate a review of the process shortly after price controls are settled. This should encourage debate while issues are fresh in everybody's mind. This should also provide an important input to the process set out for the next review.

3. Review of existing network monopoly price controls

The issues discussed within this chapter will be explored in some detail in the coming months in the working groups that Ofgem has established and through wider industry debate. We do not yet feel able to provide a detailed response to all the points raised, but we intend to contribute fully to forthcoming discussions. For now, I will provide only a few high level comments.

Areas of inconsistency – The aim should be to identify best practice, not only within the GB energy sector but also by looking at other regulators, both in the UK and internationally.

Periodicity and strength of incentives – There are a number of issues to consider here. We certainly see merit in exploring the implications of extending the duration of elements of the regulatory settlement. In an industry where assets typically last for more than 40 years, it is only limited comfort to understand the level of allowed income for a five year period. The agreement at the last review to allow a rolling adjustment to the RAB was a step forward and we now need to consider whether this should be extended to 10 years and whether an equivalent be applied to Operating Costs.

Assessing efficiency – We have already explained some of our reservations over the methodology used to assess efficiency. In particular, we think it is essential that any inter-company comparisons recognise the differences in performance levels achieved as well as the costs incurred. This is, in our view, more important than the debate over total cost modelling. We are happy to consider specific proposals based on total cost rather than separate analysis of opex and capex but, whichever approach is used, it must incorporate performance as well as cost comparison.

We would also emphasise the importance of Ofgem maintaining consistency with the approach adopted in its assessment of the impact of company mergers. We believe the only logical conclusion is now to benchmark only the separate ownership clusters that represent genuine distinctions of management. This may reduce the number of comparators but should improve the quality of comparison and reflect the approach which has already been concluded for dealing with company mergers.

Investment incentives – We see this as a particularly important part of the review. There has been debate in the Energy Review about both the appropriate level of security of supply and the impact of distributed generation. We agree that incentives to invest should be aligned with the desired outcomes, and look forward to more detailed debates on any new requirements that may be identified. We would also draw attention to the need to confirm the treatment of costs incurred in achieving targets set within the IIP (and the consequent impact on future targets) and the importance of recognising the distinction between incentives to maintain performance and those to stimulate changes in behaviour. It is odd that you express reservations over the possibility that incentives ‘distort investment decisions’ (para 3.27). If they are to be effective, they need to change behaviour. We hope to see developments of the incentive regime for the next review period, although we remain open minded on the details (for example, whether the Ofreg model should be followed) until we can more clearly see what are the policy objectives to be achieved.

Financing of activities – We are pleased to see that UK regulators are undertaking a joint review of issues associated with the estimation of the cost

of capital. We hope that this work will be shared with licensees at an early stage. We can see potential attractions in identifying different rates of return for different activities, as an element of a broader package of incentives. However it is not yet clear how such an approach can be introduced whilst retaining the apparent rigour of past assessments of the cost of capital. This is, perhaps, another area of work for the Financial Modelling Working Group.

4. The next Distribution price control review

Initial objectives – We believe the objectives identified for the review are reasonable. However, as we have mentioned in section 2 above there is one essential element missing, which is the means of resolving conflicts between these. It is the relative weight that will be applied to the objectives that will shape the detail of the next price control. This is an area where Ofgem needs to engage with Government to determine the broader priorities. We recognise that the timing of the Energy Review has not been ideal, but this should not prevent Ofgem explaining the timetable issues to Government and seeking as much clarity as possible on objectives for the future. There may be value in a tripartite meeting involving Ofgem, DTI and DNO's at which there can be a discussion of these issues.

Key issues – This section of the paper seems to focus almost exclusively on the uncertainty arising from possible growth in distributed generation. However you have already established five working groups that have a rather broader remit. These are a better representation of the key issues, covering as they do dealing with uncertainties (not just distributed generation), incentives for efficiency, customers' willingness to pay, performance comparison and the future structure of charges. Our previous presentation to you, and the discussion above, should help to add to the list of 'key issues'.

Framework for incentives and price control – We have also been thinking about how to develop the basic RPI-X approach to price control. This has led us to suggest that a more complex formula, perhaps of the form $RPI-X + I + Q$, may be more appropriate. As your paper indicates the detail can only be determined when the desired outcomes, and perhaps some specific outputs, have been identified. It is this line of thinking that has led us to stress the importance of early resolution of the role of the distribution business, and where necessary clarity of objectives in the mind of both Government and Ofgem.

Initial timetable – It is helpful to see your first thoughts on the timetable for the review. We recognise the difficulty of planning activities when there remains uncertainty over elements of the requirement specification. However, it is important that plans are developed, since the end point is unlikely to be moved. We believe it is essential that Ofgem establish the key areas of uncertainty that prevent firm planning and develop an action plan to address them. This may involve closer liaison with Government on the outcome of the Energy Review or developing means of handling uncertainty within the period of the next price control. It is essential that sufficient time is left for the

completion of business plans in which we will be able to specify the costs that must be incurred in order to meet the objectives that will be set for our business.

5. Timetable and consultation for this year's work

As I have mentioned above, we are encouraged by the approach to consultation that Ofgem has adopted and we look forward to participating in the discussions planned for the rest of this year. This is going to be an extremely busy time for us all, and it will be helpful if dates can be fixed as far in advance as is practicable. For example, we note that you proposed a workshop in September, which is to be rescheduled for October. If you are to get a good attendance, the arrangements for that workshop need to be settled very shortly.

I am conscious that there will be further opportunities to contribute to the debate initiated by your consultation, both through the workshops you have planned and through the more detailed work groups. I hope that the more general comments within this letter are helpful. I would be happy to discuss any of the matters arising with you.

Yours sincerely

Mike Boxall
Head of Electricity Regulation