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Dear Hannah

RPI–X@20 PROJECT: REGULATING ENERGY NETWORKS FOR THE FUTURE

1. The Authority's current review of the RPI–X model for monopoly network price controls is an important project which concerns a large range of stakeholders. We are pleased to contribute this response to Ofgem's first consultation document about it.

2. EDF Energy's network covers more than 29,000 square kilometres and distributes some 87 TWh of electricity annually. We are the largest distributor of electricity (by volume and regulated asset value) in the United Kingdom, distributing electricity to some eight million customers.

3. This confers on us a distinctive economic and social responsibility, and we believe that we have more than fulfilled our principal regulatory requirements, in terms of asset management, security and quality of supply, commitment to customers, and safety focused policies. Of course, further improvements can still be achieved and the present discussions with Ofgem in the context of DPCR5 will no doubt set new challenges.

4. At the same time, we are acutely aware that we are now entering a new era, in which the energy and environmental challenges that we are facing may well change the way of operating and developing networks. Security and quality of supply will remain a major economic and social requirement, but in a radically different context. We expect that, in addition to large centralised generation (notably nuclear and coal with CCS, which are crucially needed to meet carbon reduction targets), new generation technologies and smaller distributed power and renewable energy sources will develop dramatically.

5. Enhanced energy efficiency will also require more interaction between customers and networks, in particular for dealing with demand flexibility. Asset management will then need a much higher degree of automation, with wider remote control systems. In our very competitive UK energy market, new products and new services expected by customers will be provided by suppliers: that, in turn, will contribute to the need to review the relationship between distributors and suppliers, particularly in the context of a nationwide implementation of smart metering.

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6. Actions to mitigate climate change will offer a wide range of business opportunities to UK industry and we are conscious that we will have a key role to play to make it happen, subject to an appropriate regulatory framework.

7. We believe in this context that it will be even more important that network businesses are in the hands of well capitalised companies with a long-term commitment to the industry and its customers. Regulation will need to encourage this outcome, rather than one in which financially orientated businesses enter the industry simply to exploit short-term cost savings and financial engineering.

8. Against this background, while Ofgem's document invites views on a large number of specific questions, we have restricted our comments below to those which we believe can contribute most value to the ongoing progress of the review and its outcomes.

Review should focus on significant investment issues

9. Utility regulation through independent agencies governed by statutory objectives that are set by Parliament has been one of the most significant innovations of British public policy in the last 30 years. The RPI–X price cap formula for network regulation has been a consistent, and probably the most dominant, feature of this policy framework. In the energy sector, this approach has delivered some very large public benefits. Over two decades, repeated price control settlements for network businesses have achieved an equitable balance between the interests of customers and owners, which has enabled the UK to attract substantial investments at a reasonable cost of capital. This has been accompanied by an ongoing revolution in utility management, producing significant and enduring network productivity gains, a lower cost base for industry operations, and improved quality of supply and service.

10. There have, however, been some downsides to this process. Looking back with the benefit of hindsight, it can be seen that the evolution of the price control method since the energy industry's privatisation has reflected a particular focus by Ofgem and its predecessors on short-term economic efficiency. The consequence of this focus has been a minimisation of all kinds of costs, including investment, which has left the networks generally tighter and more capacity-constrained than they should be. The short-term focus has also produced investment decisions that tend to be dominated by fear of a regulatory disallowance of costs.

11. Clearly, the RPI–X model of fixed-term price caps has been best suited to sweating existing assets of the network businesses, rather than creating new ones. Of course, investment is not an end in itself: but it is essential if regulated companies are to maintain security of supply, develop network resilience, and help to deliver the national policy objective of a sustainable energy sector within the transition to a decarbonised economy. Investment issues will feature heavily in the work of the energy networks industry for at least the next ten years, and will accordingly require particular attention during this Ofgem review.

12. Against that background, the characterisation, in Ofgem's consultation document, of the energy network companies as intrinsically low risk, unresponsive organisations is neither wholly accurate, nor helpful in the search for solutions. Investors will invest whenever the returns are adequate, after allowing for risk. Ofgem cannot change investors' attitude to risk, which is determined by market conditions. However, Ofgem can take steps to increase returns and/or reduce the risk, so that network companies can more easily persuade investors to commit capital to long-term investment.

13. Currently, regulated businesses under RPI–X are motivated to innovate and invest by the short-term incentives within the price control mechanism (for example, if the investment produces a short-term cost reduction or quality of service improvement). The current regulatory system simply does not offer the surety of cost recovery needed to encourage longer-term investment, particularly of an innovative or risky type. It follows that much of the behaviour which Ofgem's paper identifies as undesirable is not an intrinsic characteristic of energy networks but, rather, is a consequence of the incentives offered by the current regulatory system, with its focus on short-term cost-minimisation and unpredictable long-term rewards.

Long-term uncertainty raises large issues for all parties

14. We agree that the incentives created by the RPI–X approach to price control have driven most of the successes of network regulation over the past 20 years. However, it is questionable if continuing with the same approach will be sufficient to deliver the substantial investment needed in the future. This long-term uncertainty raises large issues for both Ofgem and the network companies. It is essential that the industry should be able to respond to new roles as and when these appear. But Ofgem's historical focus on cost reduction and the avoidance of stranded assets has left the regulatory system not sufficiently equipped to encourage investment, without which network companies cannot adapt to major change.

15. The companies need to go beyond the focus on lean, cost-conscious delivery, in order to rebuild their intellectual capacities, if they are to respond to new challenges. The intensity of their R&D activity and funding has dipped well below the national economy average. The sector is also facing a very large skills shortage, resulting from a combination of adverse age profiles (falling supply) and rising levels of required investment (increased demand). The sharp decrease in the industry's involvement with schools and universities is the result of the companies' focus on the short-term targets and funding requirements created by the five-yearly cycle of regulatory price control reviews. It is a major weakness of Ofgem's document that the whole area of training, skills, and R&D is largely missing from its coverage.

16. The document's treatment of network companies' relations with customers is also not well balanced. There are repeated references to concerns that the network companies are not sufficiently focused on customers and their needs. However, there is no discussion of the boundary between the role of these companies and

the role of other players in the energy supply chain. The business separation of the late 1990s left gas and electricity distributors, in particular, with a very narrow range of customer contacts. As a result of deliberate policy choices made by Ofgem and its predecessors, distributors' contacts with customers are restricted, essentially, to the provision of network connections or diversions (where, typically, the customer will be a developer or public lighting authority), the restoration of power supply following a network failure, and occasional public safety issues relating to network assets.

17. Limitations are now more apparent with this model of network functions. This is mainly because certain initiatives which are necesssary to deliver energy security and a low carbon economy will require the development of an enduring relationship with customers' premises, in order to facilitate the funding of investments with payback periods that are longer than the duration of a supplier's contract and/or the owner's tenure. The areas under debate include smart metering, new community-based energy efficiency programmes, demand side management projects, the promotion and development of small-scale renewable electricity and heat, and provision of an electric vehicle charging infrastructure.

Reconsideration needed of the proper role for networks

18. Addressing all of these challenging issues in a timely and co-ordinated manner has huge implications for future network operations and activities. We acknowledge that Ofgem's LENS work has created valuable insights into a number of ways in which energy networks could be developed in response to the challenges posed by climate change and security of supply. However, Ofgem has not yet taken the necessary next step of setting out the direction that the UK's networks industry should follow. Only Ofgem can define new roles for energy networks.

19. In our view, therefore, a core feature of Ofgem's review should be reconsideration of the proper role of energy networks, with a view to allowing and, where necessary, obliging them to carry out a broader and more strategic range of functions, within the over-arching framework of national energy policy. This option would require Ofgem to specify formally a new set of the overall high-level outputs that the industry must deliver, and to set the network price controls accordingly. We are sceptical that user-led network investment will be adequate to meet urgent policy requirements. It will be difficult to form a group of consumers who encompass all of the costs and benefits associated with different projects and, in any case, some investments will be driven by the government's environmental policies, not by consumer interests.

20. Similarly, we do not see a role for the currently popular idea that some of the complexity of network price controls could be replaced by a simpler process, in which customer groups would negotiate directly with companies on the key parameters of a settlement. Consumers can only negotiate with networks efficiently if both parties understand well the starting position for the negotiation, namely precisely what

costs the regulatory system will allow the networks to recover. At the moment, there is insufficient clarity over those rules to permit such efficient negotiations.

21. So a pre-condition for negotiation with customers would be further work by Ofgem to codify the regulatory processes of a price control review. Negotiated settlements in the British context (whatever their merits under different legal jurisdictions overseas), far from simplifying regulation, would have to bring even further complexity into the picture, or else they would result in a patchwork system of second-best outcomes. In any case, complexity is not, of itself, a concern for consumers. They rightly expect their statutory proxy – Ofgem – to manage complexity on their behalf.

Investment ahead of demand will need a new emphasis

22. This is not to say that there is no value to be gained from constructive engagement with consumers at large and organised user groups. EDF Energy has been making the maximum possible use of recent consultations with customers, and some interesting messages have emerged. A persistent theme of our stakeholder engagement work in the DPCR5 process has been the commonly expressed desire that we should pump-prime economic development by providing network infrastructure ahead of need, along with a better balance between upfront connection costs and socialised network costs. However, it is not possible for networks to respond to such (legitimate) calls for action, because the current regulatory system places upon such investments a great risk that they will be regarded as inefficient or unnecessary.

23. To encourage energy networks to invest ahead of demand would require a change in the regulatory framework in order to remove such risk in cases where investment ahead of demand was desirable. So a second core feature of Ofgem's review should be recognition that, in future, the planning and investment scenarios for networks will need to be grounded as much on what is required to deliver government social and environmental policies as on signals from network users of willingness to pay.

Possibility of legislative change should be addressed

24. A third important feature, in our view, is for the question of possible legislative change to be addressed by the review. This applies firstly at the broad strategic level in relation to Ofgem's statutory remit, where there is clearly scope for a more explicit and prescriptive statement of the regulator's responsibility to ensure the reliability and proper functioning of industry operations, the adequacy of research and innovation, and the delivery of supply security on a fully sustainable basis. But it also applies at the more specific process level, particularly in relation to the role of the Competition Commission as, in effect, an appeals body against price control determinations for regulated companies. The fact that there has been no reference of a disputed price control proposal for the energy sector for more than ten years strongly suggests that network companies feel deterred from making use of this process in the way that Parliament intended, as a check and balance on regulatory decisions.

25. This neglect is hardly surprising because, under the current system for appeals, the Competition Commission re-examines all of the issues in order to reach a fresh determination, and the company itself has little or no control over the terms of the reference (which can be significant). A better system, the merits of which should be explored in the course of this review, would be for the company to have to specify the items of difference between itself and Ofgem, with the Commission being required to decide in favour of one side or the other on each such item, rather like pendulum arbitration in industrial disputes.

26. We believe that this approach – which would require new legislation – would strengthen the incentive on Ofgem to ensure that its decision on each component of the price control methodology was both appropriate and correct.

Regulatory commitment to the regulated asset base

27. Our final core expectation of this Ofgem review is that it should not disturb the regulatory commitment to the integrity of the network companies' regulated asset base. The capital-intensive nature of the industry requires a stable investment environment that, in turn, reflects a stable regulatory framework designed to ensure that investors are able to recover their long-term investment costs. Investors trust UK utility regulation to provide cost recovery over long time horizons (up to 40 years, for example, in the case of gas distribution). The predictability of the regulatory environment – regulatory certainty, in other words – is thus a basic requirement for efficient and cost-effective investment.

28. The alternative – uncertainty over the value of existing network assets – serves no purpose except to inject regulatory risk and to discourage efficient investment. Continuing regulatory commitment to the RAB is therefore crucial to the delivery of society's energy requirements.

29. We recognise that it is never possible to create a totally predictable regulatory environment. We also accept that it will not be possible for this Ofgem review to foresee all possible future contingencies. However, every effort should be made throughout the review process to maximise regulatory certainty by setting down the principles and procedures to be followed, by limiting the application of judgement to the narrowest possible range of issues, and by ensuring that such judgements are made as consistent and transparent as possible, and that they are at all times evidence-based.

30. While this approach will be important for network companies dírectly exposed to the review, the need for regulatory certainty is also of great concern for energy supply businesses. Their customers expect them to provide contracts with fixed input costs (rather than pass-through) and they therefore need confidence that the regulatory framework of the future will provide energy suppliers with enough predictability to offer such services with as little risk as possible.

31. Above all, Ofgem should resist the temptation, ever-present in major public policy reviews of this kind, to impose solutions to problems that do not exist: all review workstreams should begin with a process of investigation, and then a diagnosis and definition of the problem (for consultation with a wider audience), before setting out solutions for elaboration and evaluation.

Summary of the focus that EDF Energy is looking for

32. In summary, therefore, we look forward to positive developments in energy network regulation as a result of Ofgem's RPI–X@20 review, and would like to see a particular focus on the following objectives:

- Removal of unnecessary regulatory risk surrounding investments.
- Redefinition of the role of energy networks and energy network businesses.
- Clarification of Ofgem's duties under the law.
- Effort to make the process of a price control review (and hence the outcome of any appeals) more predictable.

33. We hope these comments are helpful, and we are keen to assist and participate in the review to the fullest possible extent.

Yours sincerely

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