CE Electric UK

REGULATING ENERGY NETWORKS FOR THE FUTURE:

RPI-X@20 EMERGING THINKING

THE RESPONSE TO OFGEM'S CONSULTATION PAPERS FROM

CE ELECTRIC UK FUNDING COMPANY

9 April 2010

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SUMMARY

General observations

1 CE is supportive of many of the changes that Ofgem is seeking to bring about under the RPI-X@20 project. With appropriate changes we believe that the RPI-X approach to network regulation will continue to provide benefits and meet the challenges of the future.

2 We are concerned to note that in a number of respects Ofgem's proposals represent a fundamental departure from the privatisation model whereby the public interest has been secured through the combination of:

- a profit-maximising entity that pursues the interests of its shareholders within the parameters of the regulatory regime; and
- a regulator with a public-interest remit equipped with carefully delineated, but nevertheless potent, enforcement and information powers.

This has resulted in a regulatory regime that balances the benefits of certainty for property owners with an appropriate degree of regulatory discretion and flexibility of response. Ofgem has not made a compelling case to move away from this model to the extent that is proposed in its emerging thinking.

Financeability

3 We are concerned that Ofgem's proposals on financeability will significantly increase regulatory risk, increase the cost of capital and undermine important efficiency incentives that are present in the existing arrangements. Ofgem's proposals suggest a diminution in the importance that Ofgem will attach to financeability considerations in future price control reviews, which is at odds with the realities of the financial markets and with Ofgem's insistence that network businesses are inherently low-risk.

4 We agree that efficient, well-managed network companies must be able to access finance on reasonable terms and that there should be no 'bail out' for inefficiency. We further agree that network companies could earn a below-average return if they failed to deliver outputs or if they delivered them inefficiently and that a very poorly performing company might, as in the competitive sector, see zero or negative returns. We would, however, expect the assumed cost of capital to be commensurate with this redefinition of risk.

5 We agree that the allowed return embedded in the regulatory settlement should relate to the riskiness of the network company's revenue and cost streams, assuming that it operates in an economic and efficient manner.

6 We do not agree with Ofgem's proposition that the depreciation charge should reflect the average expected service life of network assets. The regulatory system does not reflect or derive its outputs from accounting concepts of operating costs and capital costs and, therefore, using concepts of depreciation to determine cash flows is misleading. It would be preferable for Ofgem to adopt the vocabulary of 'payment terms' rather than of 'depreciation periods' in this context.

7 We agree that the distortions between different types of costs should be removed by equalising incentives that apply to competing costs so that a fixed percentage of total expenditure is remunerated through the regulatory asset value (RAV), which is returned as 'slow money', while the remainder is received within a year, i.e. as 'fast money'.

8 We have no objections in principle to Ofgem's use of the 'return on regulatory equity' (RORE) measure as used at DPCR5.

9 We agree that Ofgem should continue to assess the expected financial health of an efficient network company under a proposed price control and we can see why Ofgem might have concerns about reliance on the judgements of credit-rating agencies. We also agree that Ofgem should avoid the use of essentially arbitrary adjustments (e.g. accelerated depreciation) to the price control to ensure financeability. However, if a company is operationally efficient and has an actual financing structure that is broadly consistent with Ofgem's notional one (itself meant to represent an 'efficient' capital structure), Ofgem must recognise that it has an obligation to ensure a sufficient match between revenue and financing costs to prevent a company having financing difficulties.

10 Regulatory risk is the main risk a network company faces and the price control review is where the regulatory risk principally arises. Lengthening depreciation periods adds to regulatory risk because it increases the frequency of the risk before the asset is paid for.

11 Diminishing the importance of financeability considerations at price control reviews reduces the reassurance investors derive from an important contributor to regulatory confidence.

12 Moving the regulatory asset life assumption outwards from the current 20 years would have a negative impact on all our key financial ratios and would be likely to lead to a ratings downgrade and an increase in our cost of debt.

13 Ofgem proposes that the costs of long-lived assets should be recovered over the lifetimes during which those assets are expected to be operational. This approach confuses accounting depreciation with economic depreciation of assets. An efficient depreciation schedule should take account of :

- the price signals that customers should be exposed to in order to encourage efficient location and consumption decisions;

- the impact of the speed of cost recovery on the commitment regulators are able to provide to enable businesses to recover efficiently incurred costs;

- the impact of the speed of cost recovery on regulatory discipline and accountability; and

- the impact of the speed of cost recovery on the financeability of the businesses.

These factors would point towards a depreciation period far shorter than the technical life of the assets in order to facilitate efficient outcomes. Ofgem should be considering whether a higher effective depreciation rate would be appropriate in order to strengthen the price signal being sent to current customers.

14 A longer regulatory depreciation period implies a higher RAV in the longer run, which has implications for the calibration of the RORE mechanism. The higher RAV in the long run will also mean that future generations will pay more than if the existing depreciation period was retained because of the additional inflation indexation and the increased return from the higher RAV that will need to be funded from network charges. Whilst an extension to the depreciation paid may be NPV-neutral to companies, such a move will create a legacy of increased outturn prices for future customers.

15 Ofgem's suggestion that network businesses should seek out a different class of owner that attaches more value to longer-term income streams suggests that Ofgem does not recognise the reality of equity markets. We are aware of no equity investors who are indifferent to cash flows in the short to medium term.

16 Accordingly, we conclude that Ofgem's proposals on financeability are ill-judged, disconnected from the realities of the financial markets and inconsistent with its financing duty.

Outcomes, outputs, business plans and enhanced engagement

17 We agree with the general direction that is signalled in Ofgem's emerging thinking in respect of outcomes and outputs. Accordingly, we agree that the regulatory regime should focus on the desired outcomes and on the delivery of outputs related to these outcomes. Moreover, we agree that it is timely to move to 'a more outcomes-led framework'. This should enable Ofgem to put more emphasis on allowing companies that are performing well to set their own course. With this in mind we make the following observations on specific points set out in Ofgem's emerging thinking:

- We agree that network companies should demonstrate that they have engaged with the consumers of their network services and those that do so engage should be rewarded.

- Discretionary rewards can help to incentivise desired behaviours but it is unlikely that investors will commit serious sums to any project where remuneration depends upon regulatory discretion that is exercised after the event.

- Consultation with stakeholders may help to inform the debate about the more discretionary elements of the network company's future plans, but the preferences of consumers and users of the network cannot change the legal requirements that have been placed upon the licence holder. These non-discretionary components are very material and represent more than 80% of CE's investment programme. To the extent that there is difference between network operators in these areas these differences arise primarily as a result of differing interpretations of, and responses to, obligations which are framed in terms of reasonable practicability; they do not usually result from differing views of the obligation itself.

- We agree with Ofgem about the content of the new business plans and the role that plans should play at a price control review. This implies a world in which:

    - credible plans play a larger part in determining regulatory allowances (at least for some companies);

    - benchmarking plays a correspondingly smaller part (at least for those companies with credible plans); and

    - Ofgem allows the incentives present in the regime (rather than regulatory assessment) to drive efficiencies.

- We agree that the incentive framework should focus on the delivery of outputs rather than the delivery of the individual components of the business plan and that Ofgem should ensure value for money by providing network companies with a package of incentives to look for the likely lowest-total-cost solutions over the long term.

- With regard to delivery solutions based on anticipated need. Ofgem's emerging thinking is inconsistent in emphasising the low-risk nature of network businesses (when it comes to financeability and cost of capital) whilst implying a much higher risk environment system in which recovery of investment costs is subject to validation by utilisation in a changing policy context.

- In principle we agree with Ofgem that it should be possible to differentiate between companies in the assessment of plans and the incentives that apply in the forthcoming regulatory period. Ofgem should commit to a binary solution: i.e. a company whose business plans and track record were satisfactory to Ofgem should have its business plan funded without further adjustments, but a company whose plans did not pass that test should go through a full price control review process.

Third-party appeal rights

18 Conferring a third-party right of appeal at a price control review would introduce a fundamental change to the nature of the regulatory regime that would greatly diminish both the role of Ofgem and the salience of environmental considerations within the price control review process.

19 We consider that, although a case can be made that third-party rights would make an ineffective or unresponsive regulator more accountable to those whose interests it should protect, we do not believe that Ofgem's track record justifies such a change. The advantages are unlikely to outweigh the disadvantages of such an approach.

20 The case in favour of a right of appeal for consumers and generators connected to the network is stronger than the case for conferring such rights on suppliers. The reasoning that led HM Government to confer equivalent rights on passenger representatives but to deny these to airlines applies with still more force to the distinction between consumers and generators on the one hand and suppliers on the other in the energy sector.

21 We disagree that Ofgem should be the 'gatekeeper' in any preliminary assessment of a third-party appeal. This role should be performed either by the Competition Commission (CC) or by an independent panel.

22 We agree that, if a third-party right is to be introduced, this should be conferred on parties whose interests are aligned with those of the consumer. However, Ofgem's presumption that the producer and supplier interests are aligned with the consumer interest is flawed. Equally, Ofgem has not demonstrated why interests other than the consumer interests, e.g. the environment, should be disregarded and go unrepresented.

23 We agree that the grounds for challenge should have a public-interest focus, but we do not see that this should be confined to the effect on final consumers.

24 We agree with Ofgem that a purely process-based third-party right has no purpose, but we are not sure that it is possible or necessary to refuse challenges based on a combination of process and merits.

25 We can see how the awarding of costs by the CC could be used to deter the excessive or irresponsible use of a third-party merits-based right of challenge. It is not clear to us why Ofgem would limit the category of costs that might be met by the losing party to those costs incurred by Ofgem.

26 Where Ofgem and the licensee have agreed a set of price control proposals we think that there could be a *prima facie* assumption that the price control modifications should be made and that the CC reference triggered by the appeal should be conducted in parallel.

27 We respectfully suggest that Ofgem may be misdirecting itself if it thinks that it can introduce a third-party right of veto without changing the law. Parliament has laid down a scheme for the modification of licences where there is agreement between the Authority and the licensee that such modifications should be made. Ofgem's proposals would amount to a deliberate attempt to circumvent the clear intention of the statute.

Competition in delivery and innovation and structural change

28 We are concerned that Ofgem is considering seeking the authority to revoke licences in pursuit of its policy of opening up delivery to third parties. The reform that Ofgem is contemplating would undermine the property rights of those who have invested in network businesses since privatisation.

29 We understand that Ofgem sees merit in parties other than the network operator being involved in some aspects of the delivery of new investment. We already choose to subject significant parts of our capital programme and of our operational activities to competitive tender. It is not clear to us why Ofgem supposes that the incentives present in the RPI-X system are insufficient to encourage efficient competitive tendering by profit-seeking companies.

30 We are opposed to the introduction of any requirement to grant access to our networks for innovative purposes where we are not supporting or involved in a particular project.

31 We concur with the conclusions of Frontier Economics that structural changes are unnecessary for the delivery of the RPI-X@20 outcomes, although we agree that the roles of some network companies will change over time.

32 We agree that the regulatory framework should ensure that energy network companies facilitate effective competition in energy services, but we have concerns about what Ofgem may be contemplating here as it is imprecise and fails to recognise the duties and ownership rights of the network operator.

Duration of price control settlements

33 We understand the value that might be secured if it were possible to give financial commitments for longer than five years for some elements of the price control. However, the law relating to administrative discretion (which constrains the ability of a regulator to fetter its discretion) and the history of regulation (which is replete with examples of regulators being unable or unwilling to sustain prior regulatory commitments) suggest that the proposal is problematic. Moreover, as the future looks particularly uncertain at the moment; this is not the most propitious time to introduce longer-term price controls.

INTRODUCTION

1 CE Electric UK Funding Company (CE) is the UK-based parent company of the electricity distribution licence holders Northern Electric Distribution Limited (NEDL) and Yorkshire Electricity Distribution plc (YEDL). This paper is the response of CE, NEDL and YEDL to the following consultation and supporting papers published by Ofgem in January 2010:

> *Regulating energy networks for the future: RPI-X@20 Emerging Thinking* (Ref: 5/10)[1].
>
> *Regulating energy networks for the future: RPI-X@20 Emerging Thinking – Third party right to challenge our final price control decisions* (Ref: 14/10)[2].
>
> *Regulating Energy Networks for the Future: RPI-X@20 Emerging Thinking – Embedding financeability in a new regulatory framework* (Ref: 6/10)[3].

Together we refer to these three publications as the *Principal consultation papers.* In addition we offer comments upon the following associated publications:

> *RPI-X@20 Emerging Thinking consultation document – Alternative ex ante and ex post regulatory frameworks*[4].
>
> *Regulating Energy Networks for the Future: RPI-X@20 Emerging Thinking – A greater role for competition in delivery*[5].
>
> *Regulating energy networks for the future: RPI-X@20 Emerging Thinking – A specific innovation stimulus*[6].
>
> *Regulating energy networks for the future: RPI-X@20 Incentivising efficient long-term delivery of desired outcomes*[7].
>
> *Regulating energy networks for the future: RPI-X@20 Emerging Thinking - Enhanced engagement*[8].
>
> *Reckon LLP paper: Longer-term price controls: paper prepared for Ofgem's RPI-X@20 review*[9].

[1] Referred to throughout this response as the *Main Consultation.*
[2] Referred to throughout this response as the *Third party right consultation paper.*
[3] Referred to throughout this response as the *Embedding financeability consultation paper.*
[4] Referred to throughout this response as the *Ex-ante and ex-post: Supporting paper.*
[5] Referred to throughout this response as the *Competition in delivery supporting paper.*
[6] Referred to throughout this response as the *Innovation stimulus supporting paper.*
[7] Referred to throughout this response as the *Incentivising efficient delivery supporting paper.*
[8] Referred to throughout this response as the *Enhanced engagement supporting paper.*

Regulating Energy Networks for the Future: RPI-X@20 Update on domestic and EU policy context[10].

Regulating Energy Networks for the Future: RPI-X@20 Emerging Thinking Simplicity of the Framework: Issues to Consider[11].

Together we refer to these as the *Supporting papers*.

2 Collectively we shall refer to the *Principal consultation papers* and the *Supporting papers* as the *Consultation papers.* In addition we shall make reference to the following publications:

Review of the 'Ring Fence' Conditions in Network Operator Licences (Ref 30/10)[12].

Stephen Littlechild: Consumer involvement, ex-post regulation and appeal mechanisms.[13]

LECG: *Should energy consumers and energy network users have the right to appeal Ofgem price control decisions? If so, what form should the appeals process take?* (Final report 7 October 2009)[14].

CEPA LLP: *Consumers' right to appeal regulatory decisions: report to Centrica*[15].

3 In preparing this response we have chosen to provide answers to the numbered questions set out in each chapter of the *Principal consultation papers*. We have also offered our comments on the *Supporting papers* where appropriate.

4 The chapter headings (in italicised bold type in this response) and the numbered questions (reproduced in boxes in this response) are taken directly from the *Consultation papers*.

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[9] Referred to throughout this response as the *Longer term price controls.*
[10] Referred to throughout this response as the *EU policy context supporting paper.*
[11] Referred to throughout this response as the *Simplicity of the framework supporting paper.*
[12] Referred to throughout this response as the R*ing Fence consultation.*
[13] Referred to throughout this response as the *Littlechild review*.
[14] Referred to throughout this response as the *LECG paper.*
[15] Referred to throughout this response as the *CEPA paper.*

THE MAIN CONSULTATION

Chapter 1: A new regulatory framework for a sustainable energy sector.

> **Question 1:** Do you think our desired outcomes for the future regulatory framework are appropriate? Are there any we have missed?

5 We agree with Ofgem that the starting point for the RPI-X@20 project needs to be a clear view of what Ofgem wants network companies and the regulatory framework to deliver in the future. We also agree that energy network companies should play a greater role in facilitating delivery of a sustainable energy sector whilst delivering value for money for existing and future consumers. The company that delivers these outcomes efficiently should be rewarded and be able to finance its regulated activities. We therefore agree with 'Proposition 1' as stated in the *Main consultation.*

6 However, for the reasons set out in more detail in this response we do not agree that all of the changes that Ofgem is contemplating will help to encourage energy network companies to perform in this way. In particular we believe that some of the changes that Ofgem is contemplating are inconsistent with the statement in (Proposition 1) that 'a network that efficiently delivers will be financeable'.

> **Question 2:** Do you agree that we need a fundamental change to the existing 'RPI-X' frameworks to ensure these outcomes are delivered?

7 Ofgem has concluded that a fundamental change is needed in the price control framework. Ofgem's position is clearly set out in Proposition 2 of the *Main consultation,* which reads:

> 'RPI-X regulation is not broken but it is not fit for purpose for delivery of a sustainable energy sector. A fundamental change is needed in our price control framework. Our new regulatory framework would put sustainable development and more effective engagement alongside consumers at the heart of what network companies do'.

8 We respectfully disagree with Ofgem that RPI-X regulation is no longer fit for purpose and our analysis of the *Consultation papers* suggests that our disagreement is not merely semantic. Rather than fundamental change we would recommend the continuing evolution of the RPI-X approach.

9 Throughout this response we use the term RPI-X regulation to describe an overall approach to the regulation of utilities (or, more precisely, after unbundling, to the

regulation of networks). Its essential feature that distinguishes it from other forms of regulation is its reliance on controlling the price of the service, rather than the profits derived from it, during the price control period.

10 Since the control of prices as opposed to profits is the only defining characteristic of RPI-X regulation, it is not surprising that it has shown itself capable of significant development over many years in many sectors. Moreover, even the defining feature of RPI-X – the reliance on price rather than profit control – can be seen, on closer inspection, to be a matter of degree rather than an absolute.

11 It would be a mistake to suppose that, until the RPI-X@20 project was launched, regulators had slavishly applied a single method of regulation that now needs to be overhauled. Such a characterisation not only does not do justice to the approach taken by UK regulators over the last quarter of a century but also may condition the analysis that underpins the RPI-X@20 project by neglecting to emphasise RPI-X's proven track record in developing and adapting itself.

12 We agree with Ofgem that there are new and uncertain challenges for energy networks - principally the change from a focus on delivering operating-cost gains to a focus on facilitating the delivery of environmental targets, whilst maintaining security of supply. However, we see no reason why the broad form of RPI-X regulation is inappropriate for these challenges.

Question 3: Do you think the suggested new framework is the best way of delivering these outcomes in the future? Are there any aspects you would change? Have we missed any key aspects?

13 Whilst we agree with much of the intent and some of the specific policy initiatives that are proposed in the *Consultation papers*, we observe that underlying the specific policy propositions in the *Consultation papers* is an approach to the regulation of network companies that is radically different in concept from the approach that has served consumers well for the past twenty years. Ofgem rightly describes its proposals for change as 'fundamental', but it is our view that the profundity of the change that is being contemplated has, so far, escaped many commentators. Indeed, we do not think that Ofgem has brought to the attention of participants in the RPI-X@20 process quite how fundamental the changes would be. The analysis that has led us to this conclusion is set out in detail throughout this response to the *Consultation papers*. In summary, our concerns are:

- Ofgem's proposals with respect to new appeal rights for third parties[16] and the ring fence[17] represent a fundamental departure from the privatisation model, under which the public interest is secured through the combination of:

    - a profit-maximising entity that pursues the interests of its shareholders within the parameters of the regulatory regime; and

    - a regulator with a public-interest remit equipped with carefully delineated, but nevertheless potent, enforcement and information powers.

    This combination has resulted in a regulatory regime that balances the benefits of certainty for property owners with an appropriate degree of regulatory discretion and flexibility of response.

- Ofgem's proposals with regard to financeability[18] suggest a diminution in the importance that Ofgem will attach to financeability considerations in future price control reviews, which is at odds with the realities of the financial markets and with Ofgem's insistence that network businesses are inherently low-risk.

- Ofgem's proposals to lengthen regulatory depreciation periods, together with the increased emphasis on incentives over base equity returns, will place upward pressure on the cost of capital that is at variance with the model of a low-risk network business upon which many of the judgements made in the *Consultation papers* are predicated.

- Ofgem's desire to give greater prominence to the directly expressed preference of consumers and users of the network is well-intentioned, but it implies a retreat from Ofgem's proper conduct of its statutory remit together with an increased regulatory discretion that we think is both unnecessary and ill-judged.

14 Accordingly, although we do not disagree with some of the policy changes that Ofgem identifies in the *Consultation papers*, we have fundamental concerns about the unifying thread that links these disparate policies together.

[16] As set out in the *Third party right consultation paper*.
[17] As set out in the *Ring Fence consultation*. We shall reply separately to that consultation. The particular aspects of Ofgem's thinking as set out in that document that concern us are the proposals that a majority of directors of the licensed entity should have no connection with the company, the parent, or the wider group, and the inconsistency of the proposition that licensees must retain an investment-grade status with the policy direction set out in the *Consultation papers*.
[18] As set out in the *Embedding financeability consultation paper*.

Chapter 2: An outcomes-led framework

> **Question 1**: Do you agree that a new regulatory framework should focus on delivery of desired outcomes?

15 We agree that the regulatory regime should focus on the desired outcomes and that it should focus on the delivery of outputs related to these outcomes. Moreover, we agree that it is timely to move to 'a more outcomes-led framework'.

> **Question 2**: Do you have any comments on the categories of outputs related to these outcomes?

16 We agree with Ofgem's 'Proposition 3', which states that:

> 'The regulatory framework would focus on delivery of our desired outcomes for the long term.
>
> Outcomes would be reflected in outputs relating to:
>
> - reliability (of network services and the wider energy system);
> - safety;
> - environmental targets, particularly delivery of low-carbon energy services;
> - conditions for connecting to network services;
> - customer satisfaction; and
> - network-related social obligations.
>
> Where outcomes cannot be defined by clear quantitative outputs, there would be a qualitative understanding of what network companies need to deliver.'

17 We also agree with Ofgem that network companies should propose the level of each output that they intend to deliver in their plan and that, after due consideration and engagement with stakeholders, Ofgem should set the final outputs that would be associated with the price control package. This approach was pioneered at the last electricity distribution price control review (DPCR5) and we expect it to yield beneficial results over the DPCR5 period and beyond.

Question 3; Do you have any comments on how these outputs should be incorporated into the new regulatory framework?

18 Paragraph 2.12 of the *Main consultation* sets out how the outputs would operate in a regulatory framework. We think the combination of up-front financial incentives, revenue adjustments during a price control period and discretionary rewards after outputs have been delivered should enable companies to know that there will be rewards for delivery and penalties for non-delivery of outputs. However, the relative amounts that turn on each of these, and the totality of the upside and downside rewards compared with the base allowance, need careful consideration. That part of the reward/ penalty regime that is subject to through discretionary *ex-post* assessment needs particularly careful thought. Discretionary rewards can help to incentivise desired behaviours, but it is unlikely that investors will commit serious sums to any project where remuneration depends upon regulatory discretion after the event. We have made this observation with regard to the initial design of the Low Carbon Network Fund (LCNF) at DPCR5 and we hope that the representations that we have made will inform the debate over the development of that worthwhile regulatory initiative over the DPCR5 period.

Chapter 3: Effective engagement and accountability

Question 1: Do you agree that it is appropriate for network companies and Ofgem to improve their engagement with stakeholders as a way of improving the quality and legitimacy of decision making? Do you have any ideas on how to improve engagement by network companies and Ofgem?

19 One of the themes that runs through the *Consultation papers* is Ofgem's evident concern that the activities, and particularly the investment programmes, of the network companies should in future be validated more by an enhanced engagement with customers and users than through the more conventional processes of regulatory reviews and regulatory supervision. Ofgem comments that network companies can be criticised for paying more attention to Ofgem than they do to the preferences of their customers and the users of the networks.

20 Let us suppose that it is true that network companies focus more on the demands of the regulator than they do on the preferences of consumers and network users. Does it indicate that there is something wrong with the regime? We would respectfully suggest that it is both inevitable and desirable that a regulated entity should give the most serious attention to satisfying the regulator in any and every area where the regulator

elects to express an opinion or make a judgement. It is inevitable because the regulator exercises considerable discretion and its actions can have a material and very direct impact on the fortunes of the regulated entity. It is desirable because, for good reasons, the regulatory regime has been designed so that the conflicting priorities and preferences of the various interests that together comprise the public interest are concentrated and given expression in the powers and duties exercised by the regulator. Provided the regulator is doing its job properly it is no bad thing in and of itself if the network company gives precedence to satisfying the requirements of a legitimately constituted public-interest body. That does not mean that the company does not attach any importance to what the network users want but only that they are properly recognising that the ultimate decision is made by the regulator. We understand that Ofgem might prefer it if the preferences and priorities of the various parties could be given more direct expression in the regulatory process. But, in the presence of competing priorities that conflict across interest groups and even within the various groups over time, is it not better that principal responsibility for resolving these conflicts should lie with a disinterested body with a public-interest remit than that it should lie with a profit-seeking network operator? Both Ofgem and network operators should take pains to understand the preferences and priorities particularly of those whose premises are connected to their networks. If the network operator acts conscientiously and effectively in this regard its business plans will be the better for it, but it will not fundamentally change the imperative that drives the network operator.

21 Ofgem attaches importance to user validation of the business plans of network operators. Of the various classes of user interests, *supplier* validation of investment programmes is particularly problematic for distribution businesses. There are two connected issues here. The first arises because the distribution network is pre-eminently *a system*. As such the standards that apply to one exit point also apply to the exit point next door and it is not generally possible for there to be any material differentiation between the network services provided to the different suppliers of premises that are served by the same part of the network. Ofgem may point to some developments that have the potential to differentiate parts of the network by reference to the supplier to a group of exit points, but, for the foreseeable future, it is fair to presume that the services provided by distributors will be essentially uniform. The second and related issue is really one of legitimacy. Competition in supply has been designed on the principle that the customer can change his supplier at will and, crucially, that when he does so the network aspects of the service will remain unchanged. Given the transient nature of the relationship between the supplier and the occupant of any particular premises, by what right would the current supplier to any given premises seek to influence the nature and the degree of investment in the network that serves those premises (let alone the neighbouring premises to which he may not

ever have been the supplier)? For these reasons it is questionable whether suppliers have a legitimate locus in any discussion about distributors' investment programmes

22 Ofgem sets out its views with respect to effective engagement in 'Proposition 4', which states:

> 'We would continue to make final price control decisions and use effective engagement to inform our decisions.
>
> Network companies that demonstrate that they engage effectively on an ongoing basis with the consumers of their network services would be rewarded.
>
> We would adopt a multi-layered approach to engagement, building on models developed in recent years.
>
> Government would provide clarity on relevant policy developments, but would not be involved in price control related decisions.'

23 We agree that network companies should demonstrate that they have engaged with 'the consumers of their network services' and those that do so engage should be rewarded.

24 This could be achieved either by prescription or by discretionary reward. Prescription is quite possible: Ofgem could set out what it regards as best practice in consumer engagement at a price control review and Ofgem could then judge whether companies have achieved that desirable objective. A discretionary reward is also possible and has the attraction that network companies could compete with one another to demonstrate their virtue in this respect.

25 An important prior question is the class of 'consumers' (Ofgem's word) with whom it is thought desirable that a network company should engage. First of all we do not agree that engagement should necessarily be confined to 'consumers'. Individuals and bodies other than consumers (stakeholders such as local authorities, trade unions, environmental groups etc.) have interests that the network company and ultimately Ofgem need to take into account.

26 Moreover, the term 'consumer' needs some elaboration in the case of a network company. The interests of the end-consumer are clear and merit serious consideration, but they are not homogenous and neither are end-users necessarily well placed to make judgements about matters such as investment in the network. A large part of the operating and capital programme of a network company is driven by the requirements of the law that defines, albeit sometimes subjectively, what a network company is required to achieve in matters such as health and safety of the public and the company's

employees, security of supply and the adequacy and fitness for purpose of the network. Consultation with stakeholders may have educative benefit that would help to inform the debate about the more discretionary elements of the network company's future plans, but Ofgem must understand the reality that the preferences of consumers and users of the network cannot change the legal requirements that have been placed upon the licence holder.

27 With this limitation, we agree that network companies should be encouraged (or even required) to establish the preferences of end-consumers, in all their variety, to ensure that they have a complete picture of the wishes of those whom the network is there to serve.

28 Generators connected to the network and suppliers that use the network are also in a sense 'consumers' of network services. It is easier to establish their preferences (because there are fewer of them) than it is to establish the preferences of end-users. However, their views should have much less salience because the regime should be primarily directed towards meeting the interests of the consumers of energy rather than those of the producers or suppliers of that energy. The producer interest should be heard but it should take second place to the consumer interest. In important respects the interests of generators and suppliers will not be aligned to those of the consumer, to whom the current statute rightly gives pride of place. Throughout the *Consultation papers* Ofgem elides this distinction, lumping all 'stakeholders' together without recognising that producers and suppliers have different interests from consumers. This distinction is reflected in the statutory remit of the Gas and Electricity Markets Authority (the Authority), which describes the 'principal objective' in terms of the protection of the interests of *consumers* and sets out the general duties of the Authority with respect to a number of parties' interests such as the disabled, the chronically sick, pensioners, those with low incomes and those who reside in rural areas. The statute does not direct Ofgem to have regard to the interests of suppliers or generators. We think that the statute is wise to see matters in this way: generators, suppliers, transmitters and distributors are a means to an end. The analysis in the *Consultation papers* would be more complete if it reflected a distinction between the consumer, the producer and the supplier interests throughout.

29 We note in passing that the statement in Proposition 4 that 'Government … would not be involved in price control related decisions' seems to anticipate a change in the law. Under section 11(4) of the Electricity Act the Secretary of State presently has the right to direct that price control licence modifications should not be made.[19] We are not clear whether Ofgem is seeking a change in the law to remove the Secretary of State's power or whether this was an unfortunate oversight.

[19] There is an equivalent provision in the Gas Act.

Question 2: Do you think we should consider introducing a third-party merits-based right to challenge our final price control proposals?

30 Third-party right of appeal at a price control review would be a fundamental change to the nature of the regulatory regime that would greatly diminish both the role of Ofgem and the salience of environmental considerations within the price control review process. For the reasons set out below in our comments on the *Third party right consultation paper* we are opposed to this proposed change.

Chapter 4: Incentivising efficient long-term delivery

Question 1: Do you have views on our suggestion that financial commitments could be provided for longer than five years for some elements of the price control? What would be the appropriate length of this partial 'longer' period? To which aspects of the control might it be appropriate to give a longer-term commitment?

31 We understand the value that might be secured if it were possible to give financial commitments for longer than five years for some elements of the price control. However, the law relating to administrative discretion and the history of regulation suggest that the proposal is problematic.

32 The legal constraint arises from the fact that a regulator would need to be able to respond to changed circumstances and to do so in a way that served the principal objective (i.e. to protect the interests of consumers). Whilst it is easy to show in principle that the principal objective may be furthered by adhering to commitments given, it is clear that there must come a point when a regulator would feel justified in reviewing a particular treatment if it appeared to be unduly rewarding the licensee. Moreover, the history of UK regulation suggests that the regime is incapable of sustaining a regulatory treatment that no longer appears to be in the public interest. In recent times we have the following examples that undermine the confidence in the ability of regulators to honour their commitments:

- The second electricity distribution price control review was carried out within a few months of the acceptance by the Regional Electricity Companies (RECs) of the DPCR1 proposals. Although the Office of Electricity Regulation (Offer) justified the re-run of the review on the grounds of 'new information', this was a fig-leaf. The re-review occurred because of public concern that the initial price control review had been too soft.

- Even where regulators honour commitments, politics has a habit of intruding. Thus some of the 'excess profits' that the RECs made in the years prior to 1997 were clawed back through the so-called windfall tax on the privatised utilities. We do not know what advice may privately have been offered by the then Director General of Electricity Supply (DGES) to the government of the day, but we are aware of no public statement from the DGES setting out the case that the credibility of incentive regulation precluded the confiscation of profits legitimately earned under the previous regulatory regime.

- Even the highest regulator in the land has found reason to depart from the clearest possible signals that it has given in prior decisions. In its 2002 report on BAA plc the Competition Commission (CC) attempted to give investors confidence that an enhanced rate of return would apply to the T5 project beyond the period of the next price control period.[20] This was followed by the disappearance of that premium at the next price control review after the T5 investment had been undertaken.

Our purpose in making reference to these historical facts is not to dwell on what might be regarded as injustices of past regulatory behaviour but to point to the irrefutable fact that history shows that there is a very real limit to the extent that regulators can make effective and binding commitments about the future. The longer the period of the intended commitment, the greater the risk that the costs and the associated income of the licensee will get out of alignment, putting too great a pressure on the regulatory commitment. This risk is asymmetric and is unfavourable to the licensee. Where a licensee is struggling a regulator may find it easier to deny a licensee additional revenues that are contrary to the original agreement than it would to introduce changes to reduce those revenues where the licensee is enjoying returns that manifestly exceed its prevailing cost of capital.

33 The current five-year duration of price controls represents a reasonable and pragmatic solution to the twin problems that:

- too short a duration for a price control period is bad for incentives; but

- too long a period risks a serious misalignment between income and cost.

[20] The CC report included the following statement: 'We believe it is appropriate … to allow a rate of return equivalent to the cost of capital over Q4 and Q5 together at Heathrow, by smoothing or advancing revenues between quinquennia and we make our recommendations for Q4 on that basis; it will of course be for our successors to decide on the appropriate approach for Q5. But the full recovery for airlines in Q4 of revenue advancement and such adjustment for under-investment in Q3 as we believe appropriate for Heathrow should give some comfort in the CC's approach to regulatory consistency.' See CC, *BAA plc: a report on the economic regulation of the London airports companies (Heathrow Airport Ltd, Gatwick Airport Ltd and Stansted Airport Ltd)*, November 2002, paragraph 2.374.

These observations appear to us to be valid in respect of all categories of costs.

34 There is a further reason to be careful of longer-term commitments. The consultation papers rightly stress the fluidity of the present environment for network companies. A period of considerable uncertainty does not seem to be the most propitious time to introduce longer-term price controls.

35 Investors gain the confidence to make the investments that may be remunerated over a number of price control periods not primarily from the promises that regulators make about the future, but from the cumulative effect of price control reviews carried out by regulators. Every price control review that represents a reasonable settlement gives confidence that the next one will also be reasonable. The tradition that all sunk investments are remunerated at the same cost of capital as new investments gives investors confidence that sunk investments will not be subject to confiscatory treatment.

36 Accordingly, on this matter we urge Ofgem to proceed with caution and to place a very high burden of proof on the case for change. We do not rule out there being merit in a change to the duration of the period applied to some parts of the price control review, but neither are we able to point to areas of the business where we see a five-year review cycle as being any significant impediment to the efficient operation of our business. We can see that there may be scope to lengthen the horizon of the review of capital investment plans, for example, so that investment projections over a ten-year horizon are examined. a firm commitment could be made to the first five years, with an 'approval in principle' given to the second half of the ten-year period. That would give a degree of confidence to the company that the path of major expenditures is understood by the regulator and is likely to be subject to a less intrusive examination next time around. Nevertheless, in these changing times we think it unlikely that any real benefit accrues (to either side) from locking in the forecasts for an extended period.

Question 2: Do you have views on our suggestions on what business plans might look like in the new regulatory framework?

37 We agree with Ofgem about the content of the new business plans and indeed much of the content outlined in the *Consultation papers* is already present in our approach to business plans. However, we do not underestimate the change that Ofgem is seeking to introduce.

38 In particular, we agree that companies should:

- present a clear and defensible case for their business-plan proposals, demonstrating a clear link between the outcomes and the expected cost of delivery and showing that they have taken account of delivery options and credible future scenarios;

- justify the cost level for delivery with evidence of benchmarking and efficient procurement strategies;

- present evidence of how business plans have evolved over time and how they anticipate managing change in future to ensure efficient outputs;

- present evidence of effective engagement with stakeholders on the options considered;

- present evidence of how the company has worked with others on collaborative delivery options; and

- present evidence of the use of information from others (such as academics and government) on future scenarios.

39 We are pleased to see the balance struck by Ofgem in paragraph 16 of the *Main consultation*. Ofgem's guidance on the content of business plans will be important and it is clear that mandatory tables, explanatory narratives and supporting evidence will continue to feature in price control reviews. Moreover, we agree with Ofgem that it should not provide a formal business plan template for all companies to complete.

Question 3: Do you have comments on our ideas on how efficient costs might be assessed in the new regulatory framework?

40 Regulators in the UK have been accustomed to thinking that at a price control review it is necessary for them to assess the efficiency of companies with respect to one another and to anticipate the future efficiencies that are available to the sector. That may have been necessary when the scale of the efficiency gains was so great that a regulator could reasonably argue that it was necessary to anticipate future efficient cost levels rather than to rely solely on the incentive properties of RPI-X regulation to reveal these. However, in a world in which the 'lemon has been squeezed' it is not necessary for regulators to try to determine the efficient future costs of a licensee. The overall thrust of the *Main consultation* is consistent with the idea that, at least for the efficient companies who put forward coherent and credible business plans, the regulatory review process should reflect the demonstrable integrity of the plans and focus on these rather than on the further development of efficiency benchmarking.

41 One of the inferences that can be drawn from the *Consultation papers* is that licensees will start to diverge more in what they do and how they do it. Efficiency comparisons between network companies become much more problematic when the outputs differ and it is clear that Ofgem envisages companies pursuing different outcomes, and delivering different outputs reflecting the priorities that emerge from the enhanced stakeholder engagement. Benchmarking becomes more problematic as the subjects of the benchmarking become less homogenous.

42 We see the world envisaged by the *Consultation papers* as one in which:

- credible plans play a larger part in determining regulatory allowances (at least for some companies);
- benchmarking plays a correspondingly smaller part (at least for these companies); and
- Ofgem allows the incentives present in the regime (rather than regulatory assessment) to drive efficiencies.

We would welcome such a development.

> **Question 4**: Do you have comments on our ideas on how efficient long-term delivery might be incentivised in the new regulatory framework?

43 We agree that the incentive framework should focus on the delivery of outputs rather than the delivery of the individual components of the business plan and that Ofgem should ensure value for money by providing network companies with a package of incentives to look for the likely lowest-total-cost solutions over the long term.

44 The description of the design and strength of the incentive rate in paragraphs 4.21 to 4.29 of the *Main consultation*, especially the part played by:

- the fixed incentive rate;
- the retention of rewards by companies that deliver outputs;
- the penalties for non-delivery of outputs; and
- the equalisation of incentive rates for *network* costs,

is one that we recognise because it has already featured at DPCR5. We have been supportive of these developments.

45 We have set out in paragraphs 208 to 222 below our specific observation on the *Incentivising efficient delivery supporting paper*.

> **Question 5**: Do you have comments on our suggestions of how the new regulatory framework might encourage network companies to anticipate and deliver on the needs of existing and future consumers and network users?

46 We understand the emphasis that Ofgem wishes to give to encouraging network companies to anticipate future needs. Paragraph 4.31 of the *Main consultation* states Ofgem's concerns in a nutshell:

> 'The main risk with delivery solutions based on anticipated need is that any associated infrastructure may turn out to be underutilised. We want to strike a balance between encouraging network companies to anticipate what is needed, and get on with delivery, and ensuring that consumers do not pay the full cost of delivery solutions that turn out not to be needed, or not needed at the scale anticipated.'

47 Ofgem needs to decide what its policy preference is here. A higher-risk regime whereby rewards or penalties go to those who succeed or fail in making the investments in assets that are utilised may have its attractions, but it is a far cry from the current regulatory regime where disallowance of investments made has been rare (at least for distribution companies). A large uncertainty hangs over this area: the higher the risk, the higher the cost of capital. We think that the *Consultation papers* are inconsistent in emphasising the low-risk nature of network businesses (when it comes to financeability and cost of capital) but reciting the benefits of a system in which investments are subject to validation by utilisation in a changing policy context. In our view society would probably prefer to err on the side of a little too much investment because the consequences of too little compared with the costs of too much are asymmetric in favour of greater investment.

48 However, we appreciate that a case can be made on either side of this debate. Notwithstanding this, Ofgem cannot have it both ways. It cannot be argued that network companies will continue to be low-risk whilst at the same time introducing reforms that aim to sharpen the incentives by placing upon network companies a significant risk of non-remuneration where the company fails to anticipate properly the changing preferences of users and/or the changing policy context. The result of increased uncertainty in equity returns is, by definition, an increased likelihood of an unacceptably low return, which, itself, can do nothing other than increase the cost of equity.

Question 6: Do you have views on our ideas on how the interactions between charging and price review incentives might be taken into account at price reviews?

49 We agree that over the long run the structure of charges for network services can help to send signals to users about the true economic cost of using the next unit of energy, which in turn could help to contain the investment costs of the network entity. However, we are by no means certain that society (or even Ofgem) would accept a structure of network charges that sends very sharp signals to users who may be operating within the limits of a capacity that they agreed and for which they paid many years previously. Ofgem has recently recognised the problems associated with the introduction of such sharp signals with respect to embedded generators, whatever their theoretical economic merit.

50 Moreover, we understand that Ofgem wishes to place the structure of charges within new governance arrangements so that the structure of charges of the network company is not be the sole prerogative of that network company (subject to Ofgem's approval). In these circumstances the regulatory regime may legitimately encourage the licensee to bring forward changes to its structure of charges that have the desirable property of sending signals that will limit its load-related investment programme, but it must not go further than this. The discussion in the *Main consultation* would be more balanced if it recognised that Ofgem has taken steps that mean that electricity distribution licensees will no longer be in sole control of the structure of their charges.

Question 7: Do you have comments on our suggestion to treat companies differently at the price control, both in terms of process and incentives, reflecting planning and delivery performance?

51 In principle we agree with Ofgem that it should be possible to differentiate between companies in the assessment of plans and the incentives that apply in the forthcoming regulatory period. The information quality incentive (IQI) has differentiated between companies in this respect at DPCR5 and its predecessor, whilst the sliding-scale mechanism (SSM) did the same at DPCR4. There have been other features of the regime where the treatment of companies has been different.

52 However, we have not yet seen fast-track reviews for companies with credible and efficient plans. Although we would be supportive of such a development, we do not underestimate the difficulties of introducing this feature. The process by which the credibility of business plans and the validation of the track record of the licensee were assessed would have to be robust to challenge. At DPCR5 Ofgem was quite explicit

about there being an element of discretionary judgement that informed the outcome. Companies that are judged to be efficient and whose business plans are regarded as credible are unlikely to challenge the process by which this judgement has been reached. However, companies that have been assessed to be inefficient and whose plans are judged to lack credibility or completeness may (legitimately) seek to challenge the process by which such an adverse judgement has been reached. Ofgem will no doubt wish to ensure that its determinations of such matters are robust to challenge. It is not immediately clear to us that the intensity and duration of the process by which Ofgem would determine the companies that would qualify for the fast-track review would require less time or be less intrusive in its information requirements than the current full-scale price control review process.

53 Moreover, a fast-track review, although welcome in terms of resources and a shorter period of uncertainty, would not necessarily have a preferable outcome for a licensee. Ofgem would therefore need to consider whether to allow a company that had been given a fast-track review the option of undergoing a fuller review if it was not satisfied with the initial outcome. Such an option would potentially just add to the current timescales and complexity and yet, without it, some other means would need to be found to reward the company whose business plans and track record gave Ofgem confidence. In our view Ofgem should commit to a binary solution: i.e. a company whose business plans and track record were satisfactory to Ofgem should have its business plan funded without further adjustments; but a company whose plans did not pass that test should go through a full price control review process. This would incentivise the right behaviour during the regulatory period (i.e. to establish the credible track record) and it would also incentivise the production of credible business plans ahead of the review. It would be for consideration whether everything in the business plan would be left to the licensee to formulate or whether key parameters (e.g. the base cost of capital and the calibration of incentive schemes) would be determined by Ofgem either before or after the submission of the business plans by the companies.

Question 8: Do you have views on our suggestion to open up some aspects of delivery to competition?

54 Ofgem has said that the criteria for considering competitive tendering would include:

- the scale of the project;
- the extent to which the project is separable from other network activities;
- the timing of delivery of associated outcomes;

- the extent to which work has already started on a project and where logical break points lie; and

- the extent to which there is concern about the network company's proposed or forecast costs.

55 We understand that Ofgem sees merit in parties other than the network operator being involved in some aspects of the delivery of new investment. We already choose to subject significant parts of our capital programme and of our operational activities to competitive tender. It is not clear to us why Ofgem supposes that the incentives present in the RPI-X system are insufficient to encourage efficient competitive tendering by profit-seeking companies.

56 Ofgem appears to envisage that the tenders would usually be run by the network companies themselves, with Ofgem looking for evidence of efficient procurement, e.g. in the design and the build of a project, as part of the assessment of a company's business plan at the price control review.

57 At various points in the *Consultation papers* we have noted with concern Ofgem's willingness to contemplate radical departures that would fundamentally change the nature of a licensed network operator and that signal a preparedness to consider reforms that would strike at the heart of the property rights on which the privatisation model has been based. In this connection we note the following passage at paragraph 4.49 of the *Main Consultation*:

> 'We also intend to explore the potential for making greater use of our ability to revoke licences as a last resort (e.g. by strengthening the Authority's ability to revoke licences for persistent non-delivery) and franchise out some or all of the operations of the licensee.'

58 The *Main consultation* goes on to say somewhat airily that:

> 'We will consider legal aspects of these ideas for our summer 2010 recommendations, including the extent to which the existing statutory scheme may constrain proposed changes in terms of the Authority's power to revoke, and whether new legislation may be required. We will also explore the potential to require the transfer of assets, in relation to both existing assets and future pre-construction expenditure.'

59 We are concerned that Ofgem sees a change of this kind as a relatively small matter that may be impeded by some unfortunate legal constraints in the current statutory arrangements. We respectfully suggest that the reform that Ofgem appears to be

contemplating here would undermine the property rights of those who have invested in network businesses since privatisation.

60 The current licensing regime distinguishes between the *terms* of the licence and the *conditions*. The conditions of the licence are subject to the arrangements by which a regulator can propose and, if necessary, following a CC reference, impose modifications that are in the public interest. The terms of the licence, however, were placed outside the statutory process of modification and this was done quite deliberately so that the property rights of the owner of the network would be entrenched for the duration of the licence (that duration being itself a term rather than a condition). The circumstances in which a licence can be revoked were narrowly circumscribed so that investors could have confidence that their investment would not be undermined by being deprived of their licence at some future date. The Utilities Act 2000 criminalised the distribution of electricity without a licence.[21] Revocation of a licence would fundamentally change the value of the entity that owns the network assets and a change to the regime by which a licence may be revoked is therefore a very fundamental matter. We are dismayed that Ofgem seems to be prepared to consider such a fundamental change to the basis on which the privatised regime was founded.

61 No doubt Ofgem will conclude that changes to law would be necessary to achieve such a policy intention, but our concern with this, and with some other changes with which we take issue in this response, is that Ofgem's proposals amount to something that is more far-reaching than an adjustment to the *form* of incentive regulation. It represents a change to the security that the investor enjoys respect to his property. It is a matter of serious concern to us that Ofgem treats the fundamentals that underpin the regime that we have had since 1990 as matters that may be swept away in the pursuit of an adjusted form of network price control.

62 In summary, therefore, we are not opposed to competition in delivery playing a significant part in the future development of network businesses. However, we believe that the incentives for the efficient use of competitive delivery mechanisms are already present and we do not agree that Ofgem needs to take new powers to ensure that this option is used effectively.

Question 9: Do you have comments on the design of a cross-sectoral time-limited innovation stimulus that is open to a range of parties?

63 Ofgem's thinking is that the stimulus will, among other things:

[21] Until that statute was passed the unlicensed distribution of electricity was not treated as a criminal activity by the statute.

- be competitively bid for;
- be open to entities other than networks;
- provide only partial funding;
- be open to only those projects that have as their intent the facilitation of the transition to a sustainable energy sector or are expected to deliver outcomes leading to more efficient network operation; and
- replace the existing IFI and will, at least for a time, run alongside the LCNF fund, which is part of the DPCR5 settlement.

64 We can find much to support in the *Innovation stimulus supporting paper,* although we need to understand more about the detail of the competitive bidding and the concept behind the partial funding. In the LCNF established at DPCR5, it is only distribution network operators (DNOs) that may lead on innovation projects, although they are encouraged to form consortia with external partners. In the *Consultation papers,* Ofgem is proposing to make it possible for competent parties other than network companies to lead innovation projects. It is then envisaging that such parties will either involve or contract with a network company in order to access the company's network to conduct field trials.

65 These concepts will need further development but we must make clear that we are opposed to the introduction of any requirement to grant access to our networks where we are not supporting or involved in a particular project.

66 With regard to the funding, we have already been critical of the LCNF arrangements in that we are finding difficulty in identifying a clear commercial rationale for investing in large projects when all routes for recovering what amounts to a 10% 'tax' appear to be deliberately closed off by the regime itself. Innovation will only be truly stimulated by a framework where the delivery of valuable outcomes by companies leads to enhanced revenues or, at the very least, enables companies that deliver successful learning outcomes to be allowed to recover their costs. One way to achieve this would be to hold back part of the funding (say 10%) until the project has been concluded with a firm outcome. With Ofgem adopting a partial-funding approach in the *Innovation stimulus supporting paper*, it appears that Ofgem has in mind to continue to pursue a policy where the business case for innovation relies on a project-funding gap being filled by an expectation that future efficiency savings will result. However, the resetting of price control baselines at future reviews would be rightfully expected to capture such efficiency savings for the benefit of customers. We believe that the emerging thinking on stimulating innovation is therefore flawed in this respect.

Question 10: Do you have comments on our straw man on how we would embed our financeability duty into the new regulatory framework?

67 Paragraph 4.63 of the *Main consultation* summarises the 'straw man' for how Ofgem might embed financeability in a new regulatory framework. We set out our detailed comments on this in our response to the *Embedding financeability consultation paper*. In summary, our views are set out below against each of the main headings:

- *Financing duty*

  We agree that efficient, well-managed network companies must be able to access finance on reasonable terms and that there should be no 'bail out' for inefficiency. We further agree that network companies could earn a below-average return if they fail to deliver outputs or if they deliver them inefficiently and that a very poorly-performing company might, as in the competitive sector, see zero or negative returns. We would, however, expect the cost of capital to be commensurate with this redefinition of risk.

- *Allowed return*

  We agree that the allowed return embedded in the regulatory settlement should relate to the riskiness of the network company's revenue and cost streams, assuming that it operates in an economic and efficient manner. We are not sure why the allowed base return should vary across the regulated sector, driven by factors such as the size of the investment programme, but we agree that it should change by reference to the incentive structure provided by the regulatory regime.

- *Depreciation*

  We do not agree with Ofgem's proposition that the depreciation charge should reflect the average expected service life of network assets. The regulatory system does not reflect or derive its outputs from accounting concepts of operating costs and capital costs, and therefore using concepts of depreciation to determine cash flows is misleading. It would be preferable for Ofgem to adopt the vocabulary of 'payment terms' rather than of 'depreciation periods' in this context. Ofgem's focus should be on determining what the appropriate repayment period should be for assets required by a generation of customers, with particular attention being paid to ensuring that the right economic signals are being sent to those who trigger the need for the asset in the first place and to ensuring that the cost of capital is optimised. In other words, too long a repayment period dulls price signals, will tend to lead to inefficient consumption and will drive up the cost of capital, thereby increasing the overall net present value of the costs of providing the network.

- *Capitalisation policy*

  We agree that the distortions between different types of costs should be removed by equalising incentives that apply to competing costs so that a fixed percentage of total expenditure is remunerated through the regulatory asset value (RAV), which is returned as 'slow money', while the remainder is received within a year, i.e. as 'fast money'.

- *Calibrating the package*

  We have no objections in principle to Ofgem's use of the 'return on regulatory equity' (RORE) measure as used at DPCR5.

- *Checks on financial well-being*

  We agree that Ofgem should continue to assess the expected financial health of an efficient network company under a proposed price control and we can see why Ofgem might have concerns about reliance on the judgements of credit-rating agencies. However, we would note that there seems to be more precedent for credit-rating agencies *overstating* creditworthiness than *understating* it. We also agree that Ofgem should avoid the use of essentially arbitrary adjustments (e.g. accelerated depreciation) to the price control to ensure financeability.

Chapter 5: Cross-sectoral solutions for a sustainable energy sector.

> **Question 1:** Do you agree that a new regulatory framework can deliver our desired outcomes within the existing industry structure?

68 We agree with Ofgem's 'Proposition 6', which is expressed thus:

> 'The new regulatory framework can deliver within the existing industry structure. Network companies which work with others to find efficient ways of delivering outputs would be rewarded.
>
> Network companies and the regulatory framework would facilitate the emergence of viable energy service companies.'

69 We also concur with the work undertaken by Frontier Economics on the role of future energy networks that concluded that structural changes are unnecessary for the delivery

of the RPI-X@20 outcomes, although we agree that the roles of some network companies will change over time.

Question 2: Do you agree that it is appropriate to encourage network companies to work with others to identify cross-sectoral solutions to the challenges the sector faces?

70 We agree that it is appropriate to *encourage* network companies to work with others to identify cross-sectoral solutions to the challenges the sector faces. However, we have serious reservations about Ofgem's proposals to take new powers to enforce this.

Question 3: Do you agree that the regulatory framework should ensure energy network companies facilitate effective competition in energy services?

71 We agree that the regulatory framework should ensure that energy network companies facilitate effective competition in energy services, but we have concerns about what Ofgem may be contemplating here. In particular we note that:

- if energy services companies (ESCOs) are 'viable', but are not able to obtain reasonable access terms to distribution networks, Ofgem states that it would need to take action; and

- if DNOs fail to provide 'appropriate', 'fair' and 'timely' access terms, Ofgem would 'explore the potential to require network companies to lease, or even sell, assets'.

72 It is by no means clear from the *Consultation papers* what test would be used to determine an ESCO's 'viability'. Neither is it clear what criteria Ofgem would use to decide whether access terms were 'appropriate', 'fair' and 'timely'.

73 Ofgem also says that it intends 'to explore the potential to require network companies to lease, or even sell, assets if they failed to offer fair and timely terms'. Once again we are concerned at what appears to be a cavalier attitude towards the property rights of the asset owner. It is one thing to give access rights to energy service companies, but it is quite another to suggest that such open-ended enforcement risks, even amounting to the compulsory sale of assets, might be the appropriate remedy for an ill-defined problem with respect to an ESCO. Network operators are subject to serious legal obligations, not least with respect to health and safety and continuity of supply, that must take precedence over the possible desire of an ESCO to carry out an interesting experiment on part of the network.

THIRD PARTY RIGHT CONSULTATION PAPER

Chapter 1: Potential advantages and disadvantages of a third-party right of challenge

> **Question 1**: Do you have any views on the potential advantages and disadvantages of a third party merits-based right of challenge? Are there any factors that we have not identified or considered?

74 Our views on the issues raised by the possible introduction of a third-party right to challenge Ofgem's final price control decisions have been fully set out in a paper from CE's Regulation Director submitted to Ofgem in September 2009.[22] That paper was written before we had the benefit of reading the *LECG paper*, which covers the same issues, albeit from very different perspectives. The *LECG paper* makes the cogent argument that a merits-based right of challenge is likely to increase the accountability of the regulator to those whose interests the regulatory regime is supposed to protect. This is an important aspect of the argument that we had not considered in our previous submission, but those who make it should recognise that implicit in the argument is the premiss that, without this element of accountability, Ofgem would not adequately fulfil its statutory remit. It cannot logically be argued that a third-party right to challenge Ofgem's price-control decisions is necessary to improve the accountability of the regulator without conceding that, in the absence of such an enhanced accountability mechanism, Ofgem has failed, or would in future fail, adequately to protect the public interest. We are not aware of anyone having made this criticism in respect of Ofgem and the *Third party right consultation paper* does not advance this argument in favour of the introduction of a third-party right to challenge Ofgem's final price-control decisions.

75 With the exception of the point about the improved accountability of regulators (noted above), our views remain essentially the same as those set out in our September 2009 contribution. In summary, these are as follows:

- RPI-X regulation is founded on the principle that the firm will look after its own interests and that other interests must be weighed and balanced by the regulator, guided by its principal objective and its general duties;
- the public interest is encapsulated by the principal objective and the general duties. It is not the same thing as the interests of consumers, although these are pre-eminent among the various factors;

[22] *Consumers, Stakeholders and Appeal Mechanisms in the Regulation of Energy Networks.* This paper was placed by Ofgem on the RPI-X@20 website. Along with the *LECG paper* and the *CEPA paper* it was reviewed by Stephen Littlechild in the *Littlechild review*.

- the public interest and the consumer interest are served by well entrenched property rights;
- the privatisation regimes gave a direct power of veto to the person whose property rights were being constrained by the licence;
- other people's interests were protected by other aspects of the regime, including rights of veto exercisable by the Secretary of State;
- giving rights of appeal or veto to some stakeholders but not to others will reduce the influence of the non-empowered stakeholders;
- it is hard to give status to the environmental stakeholder in appeal mechanisms;
- Ofgem's role would change significantly if other parties were to be given rights of appeal or veto. It would become more of a mediator than a regulatory decision-maker;
- CC referrals would be likely to be more common (or even the norm), with the probability of such referrals being greater the more parties are given rights of veto;
- a right of appeal conferred upon customers would require representation and governance arrangements;
- whoever represented customers would need to find a way to resolve the conflicting priorities of different customer groups;
- the interests of suppliers are not aligned with those of customers, though they may sometimes coincide;
- there is a greater alignment between the interests of airlines and passengers than there is between the interests of suppliers and end users in the energy sector. Nevertheless, the Government recently concluded that, while passengers should be given appeal rights, airlines should not;
- suppliers are exposed to changes in network prices. In the past their margins have been swelled by reductions in charges until these have been competed away;
- in an era of rising network prices, suppliers' margins are reduced until the market (or the contracts) allow price rises to flow through;

- the supplier-hub principle (rather that the reality of who benefits from the network service) is the design feature that exposes the supplier to pricing risks from network charges; and
- the supplier is commercially indifferent to the experience of the end user with respect to network services.

Question 2: Taking account of our ideas on the wider regulatory framework, set out in our recently published Emerging Thinking consultation paper, particularly the role of enhanced engagement by network companies and Ofgem, do you think the advantages outweigh the disadvantages, or vice versa?

76 The proposal to introduce a merits-based third-party right to challenge Ofgem's final price-control decisions would represent a more profound change to the regulatory regime than perhaps the consultation paper acknowledges. It might have the merit that it would increase the accountability of the regulator to those whose interests the regulator is there to protect, but we have seen no serious criticism that Ofgem has failed in the past in this respect. Moreover, the introduction of such a right would represent a fundamental change in the privatisation settlement that changes the mechanism by which the property rights of a licensee can be interfered with. The privatisation regime was based on the principle that the regulated firm would look after its own interests and that other interests would be weighed and balanced by the regulator as guided by its principal objective and its general duties. A change to this approach should not be made lightly because any change to the balance of power at a price control review is likely to have profound consequences for the conduct of such reviews by all the parties concerned.

77 The essential difference between the present arrangements and those in which parties other than the licensee are given a right of appeal is that the regulator would have to satisfy not only the licensee, but also all the other parties to whom such rights have been granted before a modification to the price controls could be made by agreement.

78 It is obvious that this makes references to the CC much more likely, if only because it is harder to reach agreement amongst many people than it is between only two. The greater the number, and the greater the diversity, of the interests of the parties to whom such rights are given, the more pronounced this tendency will be.

79 Granting such rights to parties other than the licensee will significantly change the role of the regulator at a price control review. Instead of conducting a review that is essentially a bilateral process in the sense that it is focussed on delivering a set of proposals targeted at the licensee that the licensee can accept or reject (where the

tendency has been for licensees to accept), the regulator will instead conduct a review where the end product is a set of proposals that, if they are to become effective without a CC reference, must receive the approval not only of the licensee but of all the other parties that have to be satisfied.

80 For these reasons Ofgem's role will become mediatory rather than decisive because all parties will know that any of the other parties can force the matter to the CC. This would change Ofgem's behaviour, giving it more of an honest-broker role between the parties than the leadership role that it now has. Its review would be exploratory and it would rapidly be confined to facilitating multilateral discussions between the parties that had rights of veto or appeal. It would explore whether there was any basis for an agreement between the parties. In this respect the process might become less adversarial, but it is not clear that it would have much prospect of finding common ground.

81 Under such arrangements, with CC references becoming much more common, perhaps even the norm, the real consequence might well be not that everything would remain more or less the same (albeit that a new group of people would be given rights of appeal or veto in the same way that licensees have such rights within the existing arrangements) but that, effectively, no one has a meaningful right of appeal because everyone would know that Ofgem's review was merely a preliminary skirmish, or an exploration of the points at issue, before the inevitable review took place at the CC. There would be only one real review – the one at the CC. Whether this would be regarded as a good or a bad thing depends on how well Ofgem is thought to be doing its job under the present arrangements.

82 Stephen Littlechild has made an interesting observation on the debate that has taken place around this point.

> 'John France argues further that Ofgem would in effect be marginalised: it would become more of a mediator between the parties with appeal rights, and its review would be a preliminary skirmish before the real action at the CC. CEPA argues that the right to appeal will not be abused because frivolous appeals will be discouraged, and appeals can be limited in other ways, hence Ofgem's role will not be weakened. This does not really address John France's argument that the very existence of consumer appeal will lead parties to sideline Ofgem. Indeed, ironically, the more that Ofgem insists on its traditional role, and resists the role of mediator, the more likely it is that the parties will sideline Ofgem and go to appeal if they are unable to reach agreement.

But is this an argument against a right of consumer appeal? Elsewhere, regulators have actively chosen to act as mediator with a view to facilitating negotiated settlements (or constructive agreement), on the basis that these are in the mutual interest of companies and customers. They can serve this purpose better than the regulator can. The regulator's most appropriate role is to facilitate, and where necessary to act as backstop'.[23]

83 We entirely agree with Stephen Littlechild that, merely because the introduction of such an appeal mechanism would tend to diminish the role of Ofgem at a price control review, this is not in itself an argument against such a right. However, we would suggest that those who promote the introduction of new rights for third parties should acknowledge that this would change the dynamics of a price control review because it would take power away, not only from the licensee but also from the regulator.

84 There is a further problem with introducing third-party appeal rights. The RPI-X@20 project is coming at a time when the public policy priorities require the interests of one particular, but very abstract, stakeholder to be taken into account. That stakeholder is not the customer but the environment. It is not immediately obvious how environmental interests could be equipped with appeal rights.

85 One of the merits of the present arrangements (at least in legal terms) is that the interests of competing stakeholders (including the abstract stakeholder, the environment) are captured and weighted in the principal objective and the general duties of the Authority. It makes sense that a public-interest body should be given the job of reconciling these interests. Conversely, it would seem to be an odd way to fulfil this remit to introduce a process that, in its simplest form, is designed to exclude these interests.

86 Would it be possible to include other stakeholders so that environmental interests could feature in the appeals process? Perhaps it would but the question has to be asked, is it likely to improve things? Once appeal rights are introduced to such a potentially wide group of interests, the probability that the veto will be used increases and we make a CC reference much more likely.

87 In short we consider that, although a case can be made for the introduction of third-party rights, the advantages are very unlikely to outweigh the disadvantages of such an approach. We do not believe that Ofgem has failed to do its job properly in the past and we believe that the model of a regulator enjoined to take into account *all* the components that represent the public interest is, if anything, more important in the future than it has been in the past. The introduction of a third-party right to challenge the final price control decisions of a regulator would necessarily give more power to the

[23] *Littlechild review*, pp 14-15.

interests on whom the new power was conferred and therefore less discretion to the regulator in weighing those interests. The case for making the change that Ofgem is contemplating has not been adequately demonstrated.

> **Question 3:** To what extent could the design of the right of challenge, and how it is implemented (whether through existing or primary legislation), mitigate the potential disadvantages?

88 Were a third-party right to challenge the final price-control decisions of the regulator to be introduced, the design of the right to challenge would be very important in mitigating the potential disadvantages. However, we do not believe it would be possible to avoid the disadvantages that we have referred to in our answers to questions 1 and 2 above as these are fundamental to the proposition. However, we agree that, if it is decided that such new rights should be introduced, it is possible to diminish some of the disadvantages potentially associated with the over-use of the right to challenge by careful consideration of the mechanism itself.

Chapter 3: Options for introduction a third party right of challenge

> **Question 1**: Do you have any views on whether it is preferable for us to implement a third party merits-based right of challenge through existing legislation or for Government to introduce a right through a change in legislation?

89 At paragraph 3.3 of the *Third party right consultation pape*r Ofgem makes the following statement.

> ‘We think that we could introduce a merits-based challenge mechanism relating to the price control licence condition for third parties using powers contained within existing legislation. Under s12 of the Electricity Act 1989 and s24 of the Gas Act 1986 we can make a modification reference to the Competition Commission asking them to investigate and report on whether particular matters operate, or may be expected to operate, against the public interest and if so whether these adverse effects could be remedied or prevented by licence modification. When considering public interest, the Competition Commission must have regard to, but is not limited to, our principal objective and general duties.’

90 We fully understand that it is open to Ofgem to make a reference to the CC following a concern raised by any third party (i.e. a non-licensee) where Ofgem has concerns that something is operating or may be expected to operate against the public interest.

However, we are not as certain as Ofgem appears to be that it ‘could use these power to introduce a third party right of challenge at the next round of price control reviews without the need to wait to introduce a mechanism via primary legislation.’ We set out the reasons for this below.

91 It is our understanding that the way that Ofgem would seek to introduce a third-party right within the existing statutory mechanism would be that, once the licensee and Ofgem had agreed to Ofgem’s final price control proposals, these would be presented to the relevant third parties for their approval. Depending upon the precise nature of the criteria for qualification and the tests that would have to be met in the design of the appeal right, if a third party challenged the final proposals that had been agreed between Ofgem and the licensee, Ofgem would refer the matter to the CC. Whether or not the proposed modification would be made in the meantime is a matter on which Ofgem invites views and we deal with this point in paragraph 135 below.

92 We respectfully suggest that Ofgem may be misdirecting itself if it thinks that it can introduce a third-party right of veto without a prior to change the law. Parliament has laid down a scheme for the modification of licences where there is agreement between the Authority and the licensee that such modifications should be made. That provision (with respect to electricity) is set out in Section 11 of the Electricity Act 1989. Section 11(2) of that Act requires the regulator to give notice of the proposed modifications and to specify a period within which representations or objections with respect to the proposed modifications may be made. The regulator is further required to ‘consider any representations or objections which are duly made and not withdrawn.’ Parliament has stipulated one person, and one person only, on whom a right of veto is conferred at this point in the process. That person is the Secretary of State. It is not clear to us that Ofgem can simply make a policy declaration that confers on another group of people an effective right of veto at this point in the process. We accept that, if the responses to the consultation on the agreed price control modifications yield information that makes the Authority question whether it should indeed make those modifications, then it is open to the Authority to make a reference to the CC. However, we cannot see that it is consistent with the scheme of the Act for Ofgem to declare in advance that third parties will be given an effective right of veto over a set of price control modifications that the Authority has concluded are necessary to protect the public interest. Under the present statutory scheme, if Ofgem, after considering all the facts and all the representations that it has received believe that a particular modification to the licence should be made and in respect of which it has the consent of the licensee, and the Secretary of State has not used his veto, what could possibly justify Ofgem making a CC reference rather that a licence modification? We have not taken legal advice on this point, but it appears to us to be an attempt to circumvent the intention of Parliament because it is inconsistent

with the scheme set out in the Act. We would be surprised if such a change did not require primary legislation.

93 There is a further reason why primary legislation *should* be required before Ofgem introduces a merits-based right of challenge to the price control decisions of the Authority that we explain below.

94 The absence of any corresponding, directly acting right of appeal or veto being conferred upon customers (or other industry participants) in the present arrangements is not an oversight. It is the logical consequence of the design of the regime. Customers and suppliers do not *own* the property that is the subject of the interference that is represented by the licence. Moreover as the *LECG paper* points out:

> 'price controls affect the interests of networks more fundamentally than they affect the interests of most and perhaps all consumers and users. For example, if prices are set too low then a network's financial viability is at risk. It is therefore arguably proportionate that networks should have a more central role in the price control process than do consumers or users.'[24]

It is therefore not surprising that the power to say 'yes' or 'no' (in the first instance) to a change to the licence was regarded by the designers of the regime as a power that needed to be conferred only on those whose property rights were being interfered with in the public interest.

95 Now it may be objected that anyone who depends upon a monopoly service may still have vital interests that can be harmed if that service is poor or is priced at a level that is harmful to that person's interests. Why did the designers of the regime not consider that the potential adverse effects of an ill-considered price control merited the confirming of a power of veto exercisable by those who are dependent on the monopoly network?

96 The answer lies not only in the fact that the parallel between the dependent customer, or user, and the owner of the property is not an exact one, but also in the fact that the regime secures the interests of those who depend upon the network by a different route.

97 That route is pre-eminently the creation of a body whose remit is now reflected in its principal objective and its other duties. The designers of the regime did not disregard the interests of consumers. Indeed, they gave them pride of place in the overall scheme, but they promoted their interests not by establishing a symmetry of rights between the licensee on the one hand and the consumer on the other, but by recognising that the interests of licence holders and consumers are subtly, but profoundly, different.

[24] *LECG paper, paragraph 5.27*

98 However, although only the holders of licences are given direct powers to veto changes to the special conditions of their licences, it would be quite wrong to suppose that the regime was designed with no regard to the possibility that a regulator might be persuaded to propose changes to a network operator's licence that would be injurious to consumers' interests or, indeed, to the public interest.

99 The first safeguard against such an undesirable outcome is that, before any modification may be made to any person's licence, the Authority must give public notice of its intention to make the modification, allow time for 'representations or objections' to be made, and 'consider any representations or objections which are duly made and not withdrawn.'

100 Ofgem's current practice with respect to changes to the price control conditions of the licence goes rather further than is required by this duty. It consults with all persons who may be affected by a change to the price controls as it develops its thinking. That their influence can be significant is demonstrated by the similarity of the views put forward by Ofgem in the recent initial proposals for electricity distribution to the recommendations put forward by Centrica and by CEPA (acting on behalf of Centrica).

101 A safeguard against agency capture – the prospect that the regulator would be unduly influenced by the regulatee – was built into the privatisation statutes. The Gas Act 1986 and the Electricity Act 1989 each followed the precedent of the Telecommunication Act 1984 by making provision for the Secretary of State to order that an agreed licence modification should not be implemented without first being endorsed by the CC.

102 LECG mentions this but says that it is not aware of the 'original rationale for this provision'.[25] We can offer some enlightenment to those who may not have been there at the time. The Secretary of State's veto was a pragmatic solution to what was hoped, and has been shown by events, to be a largely theoretical problem. However, it should be seen for what it is, namely a long stop just in case a regulator went native. It was not an attempt to confer direct powers of appeal on consumers or their representatives.

103 Moreover, since the regulation of privately owned monopolies has been designed around the assumption that property rights should be interfered with only when, and to the extent, necessary to secure the public interest, it would be no small matter to introduce another layer of competing rights into a process that has been designed on subtly different premises. We have had twenty years of price regulation in which an exercisable right of appeal has been given only to the licence holder. The cost of capital that regulators observe from market data must be assumed to reflect all the relevant risks, including the risk attaching to future price control settlements. Unless

[25] *LECG paper*, paragraph 6.47.

we also assume that the market has priced in the risk of a change to the regulatory regime, does it not follow that any change in the balance of risk that would arise from conferring new rights of veto on parties other than the licensee would end up being reflected in a higher cost of capital? If so, why is it assumed that the overall impact of such a change would improve the position of customers? Put simply, interfering with network operators' property rights by giving a power of veto or appeal to consumers or others could certainly be done, but it would come at a price in terms of the investors' perception of risk.

104 A point that has not featured in the analysis presented by Ofgem or in the various commentaries that have appeared on this subject is that it would be inconsistent to give third parties a right of veto with respect to a *change* to the licence when they do not have a direct right to *enforce* those conditions. Enforcement of the licence is the exclusive duty of the regulator and is subject to the (limited) discretion of the regulator having regard to the principal objective and the general duties. Third parties cannot sue a licensee for the non-performance of the enforceable duties of the licensee.[26] Why would it be appropriate to give third parties direct power over changes to the licence when they have no corresponding direct power to enforce the conditions themselves? It seems rather inconsistent.

Chapter 4: Issues to consider in designing a right to challenge

> **Question 1**: Do you have any views on the issues that need to be considered when designing a third party merits-based right of challenge?

105 Ofgem has been careful to point out that the discussion of the issues to consider in designing a right of challenge for third parties as appears in Chapter 4 of the consultation paper does not reflect an assumption that such a right would be introduced but informs the decision on whether to introduce such a right. The comments we set out below are subject to the same qualification.

106 Ofgem has correctly identified most of the issues that would need to be considered in the design of a third-party right of challenge and these are captured in figure 1 of Chapter 4 of the *Third party right consultation paper*. This is reproduced below:

[26] This is the effect of section 25(3)(b) of the Electricity Act 1989. A similar provision appears in the Gas Act 1986.

Figure 1: Spectrum of options for design of a third party right of challenge

	Spectrum of options		
Gatekeeper	Competition Commission	Ofgem	Independent panel
Who can challenge?	Parties aligned with consumer interests	Parties apply through designation process	Specified parties
Grounds of challenge	Public interest focus on final consumers	Public interest focus on wider set of parties	Affect on party making challenge
Nature of challenge	Process based	Merits based	Challenge on process or merits
Scope of challenge	Single issue only	Single issue or full control	Full control only
Outcome of CC reference	Public interest decision only	CC makes recommendation on price control to Ofgem	CC makes final decision on control
Challenge timings	Timetable for all aspects of process	Timetable applicable to certain aspects	No predefined timescales
Awarding of costs	Face own costs	Face own costs and proportion of others	Face costs of all parties
Implementation of licence change	Delayed implementation	Non-challenge elements implemented	Price control implemented

Question 2: Do you have any comments on the options that could be considered in relation to each aspect of the design of the right?

107 We set out below our observations in response to this question using the subheadings that are set out in the *Third party right consultation paper.*

Who would decide whether a challenge is warranted?

108 For the reasons set out in our answer to Question 1 above we do not believe that a third-party right of challenge can be properly introduced without a change to the law. We do not therefore accept Ofgem's claim that one of the 'advantages' of Ofgem's performing the role of 'gatekeeper' is that it does not require legislative change. Moreover, we consider that the *only* argument in favour of a merits-based third-party right of challenge is that it increases the accountability of regulators with respect to those whose interests the regulator is under a duty to protect or promote. Since the role of the gatekeeper would be to carry out an initial assessment of any challenges raised to ensure that cases referred to the CC were based on robust grounds and met other criteria laid out in the design of the right to challenge, it appears to us that it would be entirely inconsistent with the underlying purpose of a third-party right of challenge for Ofgem to perform this function. It would be more consistent with the arguments in favour of a third-party right of challenge for the gatekeeper role to be performed by either the CC or by an independent panel.

Who could challenge our final price control decisions?

109 In paragraph 4.15 of the *Third party right consultation paper* Ofgem sets out a range of parties that could be affected by the outcome of the final regulatory settlement and might therefore have an interest in challenging Ofgem's decision. These include:

- domestic consumers;
- small and medium enterprises (SMEs);
- industrial and commercial consumers (I&C);
- representatives of each of these groups of consumers;
- network users (suppliers, generators and shippers);
- network companies (including independent networks);
- investors and their representatives;
- special-interest groups (e.g. groups with an interest in energy network issues in a specific locality, groups with an interest in vulnerable customers, or groups with an interest in sustainable development issues); and
- other regulators (including the Health & Safety Executive).

110 In the light of this, paragraphs 4.20 to 4.26 of the *Third party right consultation paper* set out Ofgem's emerging thinking on the parties that may be able to challenge the final regulatory settlement if such a right is introduced. Our views in respect of each of these categories of potential appellant are set out below.

- *Consumers*

111 It is difficult to envisage a meaningful third-party right of challenge that does not extend to consumers or their representatives. We agree with Ofgem that there are questions about whether it is appropriate for individual consumers to have such a right and we would therefore favour a designation process that stipulates the bodies that have standing in this respect (e.g. Consumer Focus).

112 However, there is a problem with the exercise of a consumer veto by a representative body. It is incorrect to speak of consumers as if their interests were singular. We know from customer research that consumers' preferences vary significantly and, to some extent, predictably. For example, poorer customers tend to be more price-sensitive, whereas wealthier customers are prepared to pay more, especially for environmental benefits. Customers in different parts of Great Britain express markedly different price

preferences. Yet, at some point a network must deliver the same standard of service to all who are served by that part of the network. The opportunity for individuals to express their own preferences in the form of the price-v-quality or price-v-environmental benefit trade-offs that are routinely presented by competitive markets simply cannot arise with respect to a network. Whoever has the job of 'representing' consumers must not only find out what the consumers think but develop his own means to balance their widely differing preferences.

113 This issue becomes especially complex when the balance of interests between existing and future consumers needs to be struck. The statute has recently been rearranged so that the duty to protect the interests of future consumers is more prominent. Whilst it is possible to see how a representative body might look after existing consumers, it is less clear how it would do the same with respect to future consumers.

- *Network users*

114 The position of network users is still more problematic. We should also distinguish between categories of 'network users'. Generators whose assets are connected to the network and other network operators whose assets may be connected to the licensee's network may be differentiated from suppliers who use the network to transport energy. The interests of generators and other network operators are straightforward and legitimate. It is hard to see why, if third party rights of veto are to be conferred on anyone, they should be excluded from the process.

115 The position of suppliers is rather more complicated.

116 The argument in favour of conferring appeal right on suppliers takes two forms.

117 Sometimes the argument is made that suppliers' interests are aligned with those of consumers and, since suppliers may be presumed to have the expertise and the resources necessary to participate directly in the regulatory processes, it would make sense to give the suppliers a right of veto or appeal.

118 The alternative form of this argument is that the supplier is the person who receives the bill for use of system and therefore it is the supplier who has the most direct and most legitimate interest in the outcome of a price control review of the network companies.

119 We consider both of these claims below.

120 First let us consider whether the interests of suppliers are aligned with those of the end user.

121 We must remember that the consumer cannot choose a supplier that promises him a quality of network service that is better aligned with his own interests because, whoever his supplier is, his quality of service and the network component of the price of that service will remain the same.

122 Even if we assume a perfectly competitive supply market, it does not follow that the supplier is incentivised to promote the interests of the customer with respect to network services. To give suppliers a right of veto or appeal would therefore give power to one whose interests are not aligned with those of the consumer. In this respect it would amount to conferring power without responsibility.

123 The foregoing analysis shows that the presence of a competitive *supply* market would not ensure that the interests of customers and suppliers were aligned with respect to distribution services. There is a further reason why it is surprising that Ofgem might be contemplating giving suppliers such a role. In October 2008 Ofgem concluded its Supply Probe and indicated that it was to take action 'to strengthen competitive pressure on the Big 6 suppliers'. Ofgem found that competitive pressures on suppliers 'may not be sufficient' to protect prepayment customers and that there was evidence that 'many small business consumers are unaware of their contract terms … and that this is being used by suppliers to lock in their small business customers.' Ofgem's chief executive said that whole categories of customers were being 'woefully served by energy suppliers.'[27] In order to protect customers from abuse Ofgem introduced a new non-discrimination requirement. Ofgem also had reason to be concerned with suppliers' treatment of their customers when it fined Npower £1.8m for the misselling of energy contracts to customers. This history makes it even more surprising that Ofgem might suppose that suppliers would be effective representatives or champions of the interests of the customer with respect to network services. If Ofgem is so dissatisfied with the behaviour of suppliers in areas of their businesses where they compete with one another, why might it suppose that suppliers will be good at looking after customers' interests in those areas in which there can be no competition (which is the position with regard to the network component of the overall package)?

124 But what of the argument that suppliers receive and pay for the service of transmission and distribution and that this alone is sufficient to give them a legitimacy in terms of the exercise of a veto or power of appeal?

125 We recognise that suppliers' interests can be adversely affected by price changes and particularly by price increases that are different from those that the market was expecting. However, if that is an argument for anything, it is an argument for longer notice periods or greater transparency with respect to price changes. It is not an

[27] Ofgem, *Energy Supply Probe*, 6 October 2008.

argument in favour of an ability to influence the magnitude or the sign of those price changes.

126 It takes only a moment's consideration to realise that the monopoly characteristics of networks mean that the supply market, even if it were fully competitive, could not work to protect the end consumer with respect to the transmission or distribution components of the bundled product. The supplier has an interest in competing where he can distinguish himself from his competitors. Where he cannot, he has no commercial interest in the welfare of the end user.

127 Another way of seeing this is to regard the supplier-hub principle as a fiction on which contractual agreements have been built. This is demonstrated by the fact that, if the bill for use of system were sent directly to the consumer, the supplier would have no interest in the outcome of a price control review. The suppliers' problem (or opportunity when prices are falling) arises because the commercial arrangements have been set up on the assumption that the supplier is more like an agent for the collection from end users of the use-of-system component of the charge. Inadvertently, this has given suppliers an exposure to variations (especially upward variations) in such charges and a pecuniary interest in the outcome of price control reviews where the suppliers' interests are real but are quite distinct from those of their customers.

- *Special-interest groups*

128 The position of special-interest groups (such as environmental groups and groups representing particular vulnerable customers) is also rather problematic. It might be possible to designate such groups in the manner proposed above for consumer bodies, but this would involve a regulator (or some other objective authority) making judgements about the legitimacy of the special-interest group, which might be a rather invidious task for a regulator. This is not to deny that these groups may be affected by the outcome of a final regulatory settlement or to cast doubt in any way on their legitimacy in promoting the special interest with which they are most concerned. However, we see practical problems for any regime that is predicated upon conferring rights on one such interest group that may be denied to another. Moreover, Ofgem has pointed out the risk of unwarranted challenges to a price-control settlement if a group sees a right of appeal as a way of delaying a particular activity by a network company and Ofgem is therefore considering whether it should limit the grounds for making a challenge to issues that could not be addressed elsewhere (e.g. in the planning process or in the general charging approval processes). Perhaps the best solution would be to distinguish consumer groups that are to be given a right of appeal by a process of designation, but to allow any other groups to make a case for specific consideration by the 'gatekeeper'. That case would need to establish why the special interest group considered that its views had not been properly taken into account in the final proposals

that had been agreed between the regulator and the licensee. However, we acknowledge that this is far from ideal.

On what grounds could challenges be made?

129 The grounds for mounting a challenge should be that there are legitimate concerns that Ofgem's final proposals may be expected to operate against the public interest. This would echo the tests that the CC would bring to bear when it considers a price control modification reference. Significantly, the public interest is wider than the 'consumer interest' to which Ofgem refers at paragraph 4.31 of the *Third party right consultation paper.*

What aspect of the price-control decision could be challenged?

130 We see no particular purpose being served by a purely process-based challenge that is not already served by the option of judicial review. We therefore consider that, if a third-party right of challenge is to be introduced, it should be either merits-based or a combination of process-based and merits-based.

131 Although interested parties may have a particular objection to a single issue or a specific set of issues within a proposed price control settlement, it is very difficult to separate out specific issues from the package as a whole. For example, an appellant might object to a particular aspect of the incentive arrangements that were being proposed by Ofgem. It would be very difficult for the CC to look at that issue in isolation from, say, the base cost of capital. We therefore consider that an approach that is focussed on the package as a whole would be the right one. This is despite the fact that this would be more costly and time consuming. We also accept that this makes it much more difficult for 'winners' and 'losers' to be identified, which might inhibit the introduction of a downside risk to deter the over-use of the appeal mechanism. (We deal with this point below).

What would the outcome of the challenge be?

132 Ofgem invites views on how a challenge would work in practice with respect to the output from a CC reference that was triggered by a third-party appeal.

133 We see no reason to depart from the position under the existing legislation whereby the CC provides the report to the Authority with a recommendation where it makes a finding of effects adverse to the public interest. It is also right that the Authority should have some discretion in how it implements the CC's recommendations but that the CC can veto the changes proposed by the Authority if they do not align with the CC's recommendations.

What would the timescales of any challenge be?

134 Ofgem observes that concerns have been raised that a third-party right of challenge would be lengthy and would therefore increase uncertainty of the timing and nature of price controls. We share this view, but we consider that this is inherent in the introduction of such a right. Since we consider that the use of a third-party right to challenge should result in a full consideration by the CC of the price control package as a whole, we can see no merit in any attempt to curtail the timescales of a CC reference that results from the use of the challenge. The timescales should therefore be the same as under the existing mechanism for CC references where a price control cannot be agreed between Ofgem and the licensee.

135 The approach outlined in the foregoing paragraph would be consistent with the idea that third parties should enjoy a very considerable right that would give them something approaching parity with the licensee. For the reasons set out above we do not believe the argument in favour of this has been made and we note that some advocates of third-party rights make clear that it is not their intent to elevate third parties to parity with the licensee.[28] If Ofgem's purpose is to give third parties new rights without elevating them to parity with the licensee, it would be arguable that, where a third party has challenged a set of price control proposals that Ofgem and the licensee have agreed in principle, the modification should be made and the new price controls should take effect in parallel with the reference to the CC. If the CC reached conclusions that the price control agreed between Ofgem and the licensee would indeed operate against the public interest, it could make recommendations that took into account the consequences of the period of time during which the new price control had operated prior to the implementation of the findings of the CC that resulted from the exercise of the third-party right. That would strike a balance between a third-party right and the disbenefits of a delay in the implementation of proposals that have been agreed between the regulator and the licensee. It would amount to a *prima facie* assumption that, where the regulator and the licensee agree, the modification should go ahead and should remain in place unless the CC concurs with the view of the appellant that there is something in the proposals that would, or may be, expected to operate against public interest.

Chapter 5: A potential design for debate

> **Question 1**: Do you have any comments on the potential design of a third party merits-based right of challenge?

[28]*LECG paper*, paragraph 5.27.

136 We have set out our views on the spectrum of options in our answer to Chapter 4 of the *Third party right consultation paper*. As noted earlier any comments that we make with respect to Chapters 4 and 5 of the consultation paper do not reflect a presumption that such a right should be introduced, but are provided to inform the discussion of whether to introduce such a right.

137 Figure 2, which appears in Chapter 5 of the *Third party right consultation paper*, sets out Ofgem's 'straw man' for the potential design of a third-party right of challenge. This is reproduced below.

Figure 2: Potential design of a third party right of challenge

	Spectrum of options		
Gatekeeper	Competition Commission	Ofgem	Independent panel
Who can challenge?	Parties aligned with consumer interests	Parties apply through designation process	Specified parties
Grounds of challenge	Public interest focus on final consumers	Public interest focus on wider set of parties	Affect on party making challenge
Nature of challenge	Process based	Merits based	Challenge on process or merits
Scope of challenge	Single issue only	Single issue or full control	Full control only
Outcome of CC reference	Public interest decision only	CC makes recommendation on price control to Ofgem	CC makes final decision on control
Challenge timings	Timetable for all aspects of process	Timetable applicable to certain aspects	No predefined timescales
Awarding of costs	Face own costs	Face own costs and proportion of others	Face costs of all parties
Implementation of licence change	Delayed implementation	Non-challenge elements implemented	Price control implemented

138 In summary, our views are as follows:

- We disagree that Ofgem should be the 'gatekeeper'. For the reasons set out in paragraph 108 above we think this role should be performed either by the CC or by an independent panel.

- We agree that, if a third-party right is to be introduced, this should be conferred on parties whose interests are aligned with those of the consumer. However, Ofgem's presumption that the producer and supplier interests are aligned with the consumer interest is flawed for the reasons set out above. Moreover, Ofgem has not demonstrated why interests other than the consumer interests, e.g. the environment, should be disregarded and go unrepresented.

- We agree that the grounds of challenge should have a public-interest focus, but for the reasons set out in paragraph 129 above we do not see that this should be confined to the effect on final consumers.

- Ofgem suggests a merits-based right of appeal. We agree that a purely process-based right has no purpose, but we are not sure that it is possible or necessary to refuse challenges based on a combination of process and merits.

- We cannot see how single issues can be separated out and therefore the right of appeal must relate to the entire control. We can see no argument in favour of a timetable for the process that differs from the current arrangements.

- In principle we can see how the awarding of costs by the CC could be used to deter the excessive or irresponsible use of a third-party merits-based right of challenge. However, since we do not see how the mechanism can be made to work in an 'adjudicative' sense (because the price control has to be taken as a whole), it follows that it is also difficult to decide whether an appellant has 'won' or 'lost' on the merits of the case. Perhaps this could be left to the judgement of the CC and a deterrent effect would still be in place. Furthermore, we believe that Ofgem has not considered properly how the deterrent would operate in the case of a publicly funded body such as Consumer Focus. In addition, Ofgem proposes that the parties would pay their own costs of a challenge and that the current arrangements for paying CC costs would apply. Ofgem goes on to say that there may be benefit in requiring the challenging party to face not only its own direct costs but also a proportion of Ofgem's costs. We suggest that, in addition, the licensee's costs should be brought into consideration. If a third party is to use a right of veto to trigger a CC reference, the consequences for the licensee are considerable in terms of uncertainty in the conduct of its business and in terms of the management time that it will have to devote to the reference. It is not clear to us why Ofgem would limit the category of costs that might be met by the losing party to those costs incurred by Ofgem.

- Where Ofgem and the licensee have agreed a set of price-control proposals, we think that there could be a *prima facie* assumption that the price-control modifications should be made and that the CC reference triggered by the appeal should be conducted in parallel.

Question 2: Do you have any alternative designs that you think Ofgem should consider?

139 Ofgem has now rejected the alternative approach to enhanced stakeholder engagement that would be provided by negotiated settlements as recommended by Stephen Littlechild. Although we favour the continuation of the status quo, we believe that the

negotiated-settlements approach has more to recommend it than the approach of third-party appeal rights. We have no other suggestions that we would propose to Ofgem.

EMBEDDING FINANCEABILITY CONSULTATION PAPER

Chapter 2: What do we mean by financeability

Question 1: Do you have views on our ideas on how we might interpret financeability in a new regulatory framework?

140 We agree with the summary provided in Chapter 2 of the *Embedding financeability consultation paper* of how Ofgem interprets its financing duty, including how it considers the implications for existing and future consumers. We agree that efficient, well-managed network companies should be able to finance, and be appropriately remunerated for delivering, their activities under the terms of their regulatory settlement as well as those relating to their duties and obligations with respect to the provision of reliable, secure and safe networks. We agree that efficient operation includes what activities a network company undertakes and how it carries them, out as well as the corporate and financial structure that it chooses.

141 Similarly, we have no quarrel with the proposition that it is in present and future consumers' interests that the regulatory framework does not provide excessive returns, reward inefficiency or bail out a network company that has encountered financial difficulty as a result of its own actions (or inaction); for example because of an inappropriate financial structure or poor management. We agree that the primary responsibility for the financial integrity of a network company remains with that company's management and its owners.

142 As far as Ofgem's activities are concerned, we agree that the key part of the current regulatory framework is directed towards making sure that the revenues, profits and cash flows available to efficient network companies are such that they can secure financing in a timely way and at a reasonable cost to meet the efficient costs of meeting the obligations that are placed upon licensees by the statute and by the licence.

143 We note that the considerations relating to the useful life of network assets in gas distribution are likely to differ compared with electricity distribution (principally because of the decline in supplies available from the North Sea and the need to move to a low-carbon economy). We also note the special circumstances that apply with respect to offshore transmission where the estimated life of offshore wind turbines is only 20

years because of the harsh conditions they face. Our comments reflect our position as the owner of electricity distribution networks.

Chapter 3: The current approach to financeability

Question 1: Do you have views on our overview of how financing is considered and assessed in the current regulatory frameworks? Are there other aspects of the current approach that we should be considering?

144 We consider the summary provided in Chapter 3 of the *Embedding financeability consultation paper* is a fair description of the current regulatory framework with respect to electricity distribution. We have not identified any other issues that Ofgem should be considering.

Chapter 4: Issues arising with the current approach to financeability

Question 1: Do you have views on our Emerging Thinking assessment of the potential issues with our current approach to embedding our financing duty in the regulatory framework?

145 The key propositions from the *Embedding financeability consultation paper* may be summarised as follows:

- Energy network companies are very low-risk businesses that are so securely backed by regulatory covenants that investors (or at least some categories of them) will be unconcerned about prolonged periods of negative cash flow when deciding whether to lend to, or take equity stakes in, these businesses.

- Short-term financial ratios, which have so much influence on credit ratings, should be disregarded by putative lenders and equity investors, who should focus only on whether the businesses will earn an adequate rate of return in the long term.

- Regulatory asset lives should be set on the basis of the average expected useful lives of the relevant assets; for electricity distributors this would imply a slowing down of regulated revenues.

- No financeability adjustments would be needed at a price control review. The *Embedding financeability consultation paper* suggests that the obligation to maintain investment-grade status could be dropped (but the more recent *Ring Fence consultation paper* suggests it should be kept as a licence obligation).

- Insofar as energy network companies have (debt or equity) investors who do worry about short-term financial ratios, they should consider looking to attract a different class of investor who would be more focused on the long term.

146 We regard this paper as being disconnected from reality. Even where the cost of capital may be assumed to be set correctly, we do not believe that there really are equity investors who are indifferent to cash flow. We also question what would happen to the weighted average cost of capital (WACC) if Ofgem made this policy switch. Regulatory risk increases as the depreciation period increases because no regulator can make credible commitments about the future earnings stream. Prolonging the period of time over which investors recover their money simply increases the number of regulatory reviews upon which remuneration of a given investment depends.

147 Ofgem's paper effectively disputes the need to ensure that energy network companies' revenues deliver the sort of financial ratios that contribute to the retention of an investment-grade credit rating and are conventionally seen as underpinning the ability of networks to be financed at minimum cost.

148 Ofgem's position is not consistent with its financing duty. Although we understand Ofgem's objection to the practice of making special adjustments to revenues to compensate when a company faces financing difficulties associated with inefficiency, a highly leveraged financial structure or a short-term mismatch between revenue and financing costs, these circumstances must be distinguished from the need to ensure that an efficient operator can effectively finance its business. If a company is operationally efficient and has an actual financing structure broadly consistent with Ofgem's notional one (itself meant to represent an 'efficient' capital structure), then it is hard to see how Ofgem can avoid recognising that it has an obligation to ensure a sufficient match between revenue and financing costs to prevent a company having financing difficulties.

149 Ofgem's proposals would be likely to raise the financing costs of network companies and, therefore, the NPV of costs. As a result, any short-term benefit to existing consumers from the delaying of revenues would be at the expense of existing and future consumers in aggregate.

150 Ofgem sees energy network companies as extremely low-risk, but aspects of the RPI – X@20 project are about how to sharpen incentives and thereby increase the risks for network companies as evidenced by:

- an increase in the scope for regulatory discretion;

- active consideration of (partial) longer-term price controls with the higher risks that these would entail;

- doubts expressed by Ofgem about the merits of existing uncertainty-mitigation mechanisms, which give licensees some protection; and

- Ofgem's willingness to consider increased competition for delivery of network outcomes, albeit that it has somewhat retreated from positions canvassed earlier in the review.

151 One of the key features of the regulatory ring fence for energy network companies is the obligation to maintain an investment-grade credit rating. –This implies a need to satisfy the rating agencies' criteria, including criteria in relation to short-term financial ratios, for an investment-grade credit rating. In the *Ring Fence consultation paper* Ofgem rejects the option of removing the obligation on network companies to maintain an investment-grade credit rating whilst in the *Consultation papers* Ofgem denies that it needs to apply this criterion itself at the price control review. We believe this to be inconsistent.

152 Financeability is a distinct issue from profitability. Profitability has never, by itself, been sufficient to ensure a company's financial survival, let alone its ability to access those parts of the capital markets that are available only to companies with an investment-grade credit rating.

153 Ofgem implicitly seems to want a *higher* proportion of equity in network companies' balance sheets, since this is the remedy it suggests for a company that finds that its financial ratios are stretched. In the past Ofgem has been careful to be agnostic about capital structure, but, if it is now signalling that more equity is needed, we might well agree with Ofgem about this. However, the corollary of this must be a lower gearing assumption in the notional capital structure used in the price control review calculations. A lower gearing assumption implies a higher WACC.

154 Ofgem should avoid the vocabulary of accountancy (i.e. 'depreciation' of the RAV) and should instead start talking about 'payment terms' in relation to the RAV. We explain this in more detail below. Using the wrong vocabulary encourages participants in the debate to make the simple (but erroneous) link between the accounting lives in the statutory accounts of the companies and the 'regulatory depreciation' period assumed for the RAV.

155 Ofgem appears to be opposed to the use of asset lives to maintain financeability, but appears to be more open to using changes to the ratio of 'fast' to 'slow' money to ease financeability problems. It is not clear that this distinction makes sense in terms of Ofgem's concerns about issues like intergenerational fairness. Changes in either the regulatory capitalisation rate (e.g. the 85% used for DNOs' network spend in DPCR5)

or assumed regulatory asset lives will both alter the proportion of costs borne by existing consumers.

156 We are particularly concerned about Ofgem's proposals with respect to the increase in the regulatory depreciation period. The basis of our concern is as follows:

- Regulatory risk is the main risk a DNO faces.
- A 20-year depreciation period implies four price control reviews. A 40-year life implies eight price control reviews.
- The price control review is where the regulatory risk principally arises.
- Lengthening depreciation periods adds to regulatory risk because it increases the frequency of the risk before the asset is paid for.
- Diminishing the importance of financeability considerations at price control reviews reduces another contributor to regulatory confidence.
- Ofgem cannot tell the debt markets to 'look through' deteriorating credit metrics.
- Longer depreciation periods may threaten the dividend capacity of the licensee, thereby increasing the dependency of the shareholder on regulatory behaviour at each review.

157 For these reasons:

- longer depreciation periods increase regulatory risk and increase the WACC; and, conversely,
- shorter depreciation periods reduce regulatory risk and send better signals to end users.

158 Moving the regulatory asset life assumption from 20 years to 40 years would have a negative impact on all our key financial ratios and, overall, would be likely to lead to a ratings downgrade. Some ratios, e.g. net debt to RAV, would be less affected as a longer investment-recovery period would increase RAV as well as drive up debt. However, interest cover and other liquidity ratios would be more severely reduced as cash flows diminished.

159 As a result of the weakened ratios and, based on current market conditions, the reduction would increase our cost of debt by at least 35bps. In addition, the overall quantum of debt issuances by distributors would increase as a result of the revenue shortfalls and the continued need to fund our capex programmes going forward. We

cannot predict what effect this would have on market appetite for DNO debt, but we do not see external effects that increase the demand in line with the implied increase in supply.

> **Question 2:** Is there merit in determining a set of clear and transparent principles that guide our judgements on financeability and related policy issues for price controls?

160 We agree with Ofgem that it may be beneficial to establish a clear set of published principles that would be transparent to investors and that would enable Ofgem to take consistent decisions on the detailed application of the principles from one price control review to another in a way that is predictable. This would cover the application of the framework and, particularly, matters such as the allowed rate of return, depreciation, capitalisation policy and the calibration of returns.

> **Question 3:** How should we strike an appropriate balance between the interests of current and future consumers in determining the approach to depreciation (and assumed asset lives) and capitalisation? What are the potential implications of changing our approach on asset lives?

161 The *Embedding financeability consultation paper* uses the vocabulary of accountancy and therefore encourages the view that assets that enter the RAV are 'depreciated', whereas costs that do not enter the RAV are paid for on a pay-as-you-go basis. However, for a long time now there has been a very tenuous link indeed between accountancy concepts, such as depreciation, and the nature of the price control settlement. It is more helpful to think in terms of payment terms. That is to say, the licensee incurs certain costs in meeting its duties and the balance between the costs that enter the RAV (and are remunerated through slow money) and the costs that do not enter the RAV (that are remunerated on a pay-as-you-go basis) should be regarded as essentially the terms on which customers pay for the service that they receive.

162 Ofgem asks what are the potential implications of changing its approach on asset lives. The problem with slowing down the rate at which the RAV is remunerated is linked to the problem of the cost of capital. Each cost-of-capital decision, once made, is actually irrelevant to the marginal investment incentive in the period in respect of which the decision has been made. This is because the cost of capital is used in the price control settlement as one of the components of the building blocks that determine, *ex ante*, allowed income. Once the price control has been set, the incentive on the licensee is, quite properly, to avoid making unnecessary investments and to delay as long as is prudent the investments that are indeed necessary. Sometimes regulated companies

make the straightforward claim that a higher cost of capital will encourage marginal investments, whereas a lower cost of capital will discourage such investments. However, the argument that a higher cost of capital will encourage marginal investment is not based on the premiss that the marginal decision to invest is more attractive when a regulator has assumed a higher cost of capital; rather it stems from the fact that the investors look at the behaviour of regulators over a period of time and, if they perceive that a regulator consistently applies a reasonable cost of capital at each regulatory review, that builds investor confidence in the regulatory regime as a whole. Clearly, the longer the period of time over which investors will be remunerated for their investments, the greater the risk that attaches to that investment. It is not possible to elongate the period over which remuneration is provided without increasing an investor's perception of risk.

163 Moreover, Ofgem's view that:

> 'there may … be a rationale for placing less, or no, emphasis on short-term cash flow ratios and the levels assumed by the ratings agencies and either ignoring ratios or considering a set of ratios that more accurately captures the particular features of energy networks and considering the level of these over the long term rather than a five-year price control period…'

is particularly alarming. Investors have become accustomed to the notion that Ofgem is mindful of the need to ensure that the credit rating of the licensee should not fall outside the limits specified in the licence. This has given investors confidence in the idea that at each subsequent price control review Ofgem will look at the cash flow available to the licensee and will ensure that an efficient licensee is able to finance its activities and secure that investment-grade status. Any retreat on the part of Ofgem from a recognition of the reality that a licensee must be able to finance its business from year to year will be regarded by investors as a diminution in the security that they have about the remuneration of the assets over their lifetime. In other words, the financing duty, as currently interpreted, gives investors confidence that Ofgem will retain a sense of business reality as it approaches each price control review. Ofgem should therefore be very careful about announcing a change in its approach to financeability that could have serious repercussions with respect to the cost of capital.

164 The higher RAV in the long run will also mean that future generations will pay more than if the existing depreciation period was retained because of the additional inflation indexation and the increased return from the higher RAV that will need to be funded from network charges. Whilst an extension to the depreciation paid may be NPV-neutral to companies, such a move will create a legacy of increased outturn prices for future customers.

Question 4: How much weight should be placed on ensuring that aggregate revenues reflect the economic cost of running the network so as to ensure that consumers and users face appropriate price signals?

165 This issue arose in a limited form at DPCR5. Accordingly, CE submitted to Ofgem a paper from Frontier Economics that we have drawn on in the paragraphs that follow.

166 From a purely accounting perspective, at first sight it might seem sensible to recover the costs of long-lived assets over the lifetimes that those assets are expected to be operational. This is the proposition put forward in the *Embedding financeability consultation paper*. However, such an approach confuses accounting depreciation with economic depreciation of assets.[29]

167 An efficient depreciation schedule should take account of the following factors:

- the price signals that customers should be exposed to in order to encourage efficient location and consumption decisions;
- the impact of the speed of cost recovery on the commitment regulators are able to provide to enable businesses to recover efficiently incurred costs;
- the impact of the speed of cost recovery on regulatory discipline and accountability; and
- the impact of the speed of cost recovery on the financeability of the businesses.

168 All of these factors would point towards a depreciation period far shorter than the technical life of the assets in order to facilitate efficient outcomes.

169 The concept of economic depreciation – as opposed to accounting depreciation rules – is relatively straightforward: when capacity is plentiful relative to demand the depreciation charge embodied in prices to customers should be low to encourage utilisation of the assets; and when the capacity/demand balance is tight, the depreciation charge should be high both to signal the need for new investment and to ensure that the assets are consumed by those who value them most highly.

170 Economic depreciation cannot be applied mechanistically because the development of price controls under RPI-X regulation has depended upon inputs derived from an accounting identity. That is, the allowable revenue for a distributor is equal to the

[29] This point was made by Ralph Turvey nearly forty years ago: 'While accounting depreciation is determined by some simple rule – straight-line, diminishing balance, etc – and by an arbitrary choice of life, economic depreciation is the result of an explicit optimisation calculation.' R Turvey (1971), Economic Analysis and Public Enterprise, Allen and Unwin, London.

(discounted) sum of expected operating expenditures plus a return on an index-linked asset value plus an arbitrary straight-line depreciation charge on an arbitrary asset life. It is unlikely to be feasible, or desirable, to replace that well-understood rule with a pricing rule based on an optimisation calculation of the level of economic depreciation, since to do so would fundamentally alter the dynamic of the relationship between the regulator and the distributors. However, simply because one should not abandon arbitrary depreciation rules in favour of optimised economic depreciation rules does not mean that a regulator should not try to seek to mimic the economic effect of an economic depreciation schedule in a regulatory accounting schedule.

171 A sensible starting point in evaluating what an economic depreciation schedule might look like is to recognise that economic depreciation is closely linked to the concept of marginal-cost pricing, which Ofgem is presently seeking to promote through the common charging methodology applied to DNOs. When capacity is plentiful, the marginal cost of serving additional demand is low; and the marginal cost is high when capacity is scarce. The economic depreciation charge should therefore be seen in the same light as marginal-cost pricing in that it seeks to encourage efficient locational and consumption decisions within and across networks.

172 In its consultations and decisions on the structure of distribution use of system charges, Ofgem has indicated a preference for tariff-setting models that are based on long-run incremental costs in order to encourage economic efficiency. The underlying rationale is that tariffs should signal to users the cost consequences of their consumption decisions.

173 However, the difficulty under the present regulatory arrangements is that the target revenue base – a key determinant of tariffs - is not only not based on a forward-looking assessment of how incremental demand might drive future costs, but does not even accord closely with recent historical capital expenditure. Instead, revenue allowances are based on recovering historical costs and a proportion of costs in the immediate five-year future.

174 Consequently, even if the tariff ‘benchmarks’ produced by typical network company tariff-charging models are well designed and appropriately embody long-term incremental costs, these must be scaled in order that they match the allowed revenue target. The prices that result from this process will not (except by accident) signal the degree of scarcity or the extent to which future consumption decisions might drive incremental cost. The present environment of increased investment needs is suggestive of an increasing scarcity of capacity that would merit further regulatory consideration of whether the target level of revenue recovery to which tariff yardsticks will be scaled should more closely reflect expected future network costs, rather than historical network costs, while still allowing recovery of historical expenditure.

175 Ofgem has considerable discretion in its regulation of networks, in terms of the level of costs it allows the businesses to recover through the price control, the speed with which those costs can be recovered, and the incentives embodied in the cost-recovery mechanisms. This discretion has both advantages and drawbacks, in the sense that it enables flexibility of regulatory response to unforeseen events, but also makes it very difficult for the regulator to commit to a particular course of action. Credible commitment to long-term objectives is desirable because it prevents the regulator from taking benefits in the short run that could compromise those long-run objectives. Good regulation strikes the right balance between flexibility to deal with short-run shocks and credible commitment to long-term goals, which is crucial to promote dynamic efficiency.

176 The speed of cost recovery raises two important credibility issues that could impact on incentives to maintain and improve dynamic efficiency. The first is the familiar one that regulators are unable credibly to commit to very slow recovery of costs (for example through long depreciation periods), and regulatory risk through possible stranding of assets will increase with the effective length of time over which companies are able to recover their costs. Adoption of longer depreciation periods may reduce the cost borne by current customers through depreciation charges in any particular period, but it may also have the offsetting effect of raising the cost of capital required to finance the assets and/or reducing the investment that is actually made.

177 The second credibility issue is rooted in the strand of economic theory that emphasises government failure as a source of inefficiency, analogous to the better-known problem of market failure. Whereas markets may fail to generate efficient outcomes for a variety of reasons (the presence of externalities, information asymmetries and conditions that give rise to monopolies, etc), government failure may also encompass failure to deliver efficient outcomes due to, for example, rent-seeking by government agencies leading to capture by interest groups; and populist or electoral pressure that forces agencies to reject efficient solutions in favour of electorally acceptable ones.

178 If the speed of cost recovery is too slow, this can have the effect of increasing the attractiveness of rent-seeking by regulatory agencies because the cost to customers of that behaviour is obscured by the long depreciation period. For example, there may be an increased concern that regulators may have less incentive to evaluate thoroughly the cost submissions made by businesses, or may acquiesce in passing through costs that are not necessary for the provision of the service but are politically convenient to load onto customers. Consequently, a faster rate of cost recovery can have the beneficial effect of disciplining the regulatory agency to act effectively and in accordance with its obligations.

179 The issue of regulatory depreciation periods is linked to the question of the role played by financeability in the regulatory system. Financeability considerations have been a relevant component of price-control determinations since the electricity, gas, telecoms and water businesses were privatised and subjected to incentive-based regulation, and have probably been made most explicit, over the longest period of time, in the water sector.

180 The role of the financeability tests is, in essence, to maintain investment-grade status, usually by ensuring sufficient cash flow is generated by the business. In principle it is worth reflecting on why such tests are necessary if every component of the price control calculation is objectively correct. The answer is likely to be that the price control calculation itself does not capture all of the factors that provide the right signals for management to invest and for investors to provide the funds. The most obvious example of this problem is that in some situations it is likely that investors and businesses may not believe that the regulatory authority will be able to continue to make the objectively correct decisions at all times in the long lives of the assets that are going to be sunk. In other words, the regulatory authority is not able credibly to commit to the recovery of sunk costs over long periods. Indeed, the explicit financeability metrics designed by Ofwat in the early 1990s resulted in part because Ofwat, as a new regulator, had not been able to establish credibility in the financial markets, and so the tests were designed to restrict Ofwat's own room to manoeuvre to push cost recovery too far into the future.

181 It is often argued that, if there is an impending cycle of investment that regulatory depreciation on historical investment would not be able to cover, then this could create cash-flow difficulties for the business, and hence a threat to its investment-grade status, which financeability criteria exist to deal with. In this case, however, it is clear that the problem is that the depreciation lives are likely to be too long from an economic perspective. As discussed above, in situations where the demand-capacity balance is tight, or if new demands are being made on the network for which capacity is currently inadequate, then these resource costs should be signalled to the customers who are creating them.

182 These two examples have served to show that financeability considerations are important to regulatory regimes, since they serve as a backstop to the formal arrangements and capture characteristics in the formal regime that are either inadequate (e.g. regulatory reputation) or wrongly specified (e.g. the regulatory valuation of the assets, the WACC or length of depreciation period). Indeed, the low cost of capital that regulators have been able to derive from market data, and to make use of for the benefit of customers, is in part a function of the financial markets' expectation that financeability criteria will be applied and also that the timescales within which

investments will be recouped will be consistent with the depreciation lives assumed in the price control reviews of the recent past. The relevance to the speed with which costs are recovered is clear – if the underlying depreciation schedules either do not reflect the capacity-demand balance or provide an inadequate prospect of cost recovery over the life of the assets, then financeability considerations will be brought into play.

183 As discussed above, the regulatory depreciation span for costs incurred in maintaining and developing a network should be well below the technical lifetime of distribution assets. Indeed, in practice we observe that in competitive markets effective depreciation periods that companies use in appraising similar major investment projects are well below the technical lifetime of the assets. For example, evidence from the entry of independent power producers (IPPs) during the 1990s suggested that these plants operated on business plans that embodied asset lifetimes significantly shorter than the technical life, and long-term contracts for the sale of the power.

184 At DPCR4 and DPCR5 those costs that were remunerated through the RAV as 'slow money' were depreciated at a 20-year rate, while a significant proportion of network costs were recovered by companies on a pay-as-you-go basis.

185 Whilst all of the factors discussed above have led to the use of 20 years as the regulatory asset life for electricity distribution assets, it is likely that this was primarily due to the fact that the regulatory asset value in the price control calculation was too low from an economic perspective – which first necessitated bringing financeability considerations into play. The DNOs were privatised in 1990 at values significantly less than the economic value of the assets (which for these purposes can be approximated by the modern equivalent asset value), and it was these values that were used as the basis for regulatory asset valuation. This under-valuation in turn meant that both the expected returns and cash flows generated by the DNOs were lower than their respective economic values. Within this environment, lengthy depreciation periods would have further diminished cash flow and compromised the investment-grade status of the DNOs. So, whilst the regulatory valuation may have promoted an equitable settlement between customers and shareholders, given the original flotation values, this valuation would have led to unsustainably low cash flows, which would have needed to be remedied either by shorter depreciation lives or by a higher cost of capital. As it is, the depreciation life has been the parameter used to ensure an adequate flow of cash to ensure that the businesses remain viable.

186 These issues will continue to influence the extent to which cost recovery can (or should) be pushed too far into the future, but the key difference with the recent past is that the scale of investment that is expected over the next 20 years is clearly indicative of a tightening demand-supply balance on the networks and, far from considering a longer regulatory depreciation period, Ofgem should be considering whether a higher

effective depreciation rate would be appropriate in order to strengthen the price signal being sent to current customers.

187 We conclude our answer to this Question 4 with the observation that the fact that Ofgem has offered this financeability straw man is an example of the kind of behaviour that increases investors' perceptions of regulatory risk. DPCR5 has only just been concluded, at which Ofgem applied a regulatory depreciation period of 20 years. Within a couple of months it then published a straw man that implied perhaps a doubling of that period. Through its recent practice at price control reviews Ofgem has given investors a clear understanding about the period over which investments will be remunerated. It is unacceptable that Ofgem should now suggest that a longer period may be applied; it is particularly unacceptable with respect to investments that were made when Ofgem's previous approach applied.

188 In summary, we would commend to Ofgem the benefits of regulatory consistency and the merits of a frank acceptance that the repayment period for regulated assets should, like non-regulated assets in other sectors, be shorter than their technical life.

Question 5: Does the approach taken in DPCR5 of using RoRE analysis to calibrate the regulatory package as a whole remain appropriate going forward?

189 Although we may have been a little slow to pick up on its significance, we recognise that the RORE analysis played a useful part in informing Ofgem at DPCR5, although we do have specific issues with some of the component parts of the analysis. Nevertheless we look forward to its continued use and development in future price control reviews.

190 A longer regulatory depreciation period also implies a higher RAV in the longer run, which has implications for the calibration of the RORE mechanism. The higher RAV would presumably need to be funded through larger equity investments, along with increased amounts of debt in absolute terms. This leads to the following observations:

- With a larger equity component, incentive schemes would need to have enhanced power in order to achieve the same range of potential equity returns that are in place at DPCR5.
- Enhancing the power of a given incentive may not be appropriate from the point of view of that particular incentive scheme, but failure to do so would risk diminishing the incentives for equity investors to put in place measures to deliver good outcomes for network customers.

- Another way to place equity investors in the same position would be for Ofgem to increase the assumed financial gearing, although this might imply levels of gearing well beyond those currently observed.
- From an overall investor point of view, the returns from simply having a large RAV could become more important than the returns that are available from running the business well from a customer viewpoint.

191 Overall this could lead to worse outcomes than Ofgem would desire and we suggest that Ofgem gives further thought to these aspects.

Question 6: Is there merit in providing differentiated allowed rates of return for companies within a given sector?

192 Ofgem should be cautious about introducing any differentiated rates of return where the difference is argued to be justified by reference to matters such as 'different topographical areas (e.g. large urban areas versus small rural ones) or because some companies operate on a very different scale'. One of the underlying characteristics of the RPI-X regime as it has been practised so far is that *all* sunk investments attract the cost of capital that Ofgem deems to be necessary to attract the marginal investment. This has given investors confidence that over the lifetime of the asset (which may be several price control review periods that may span periods when the licensee is cash positive and when the licensee is cash negative) the prevailing cost of capital will be applied. It is not clear to us that either differences in topographical areas or differences in scale (with the limits of the different DNOs) would justify a different base cost of capital for the companies concerned.

193 However, we see merit in the RORE approach, which effectively differentiates the returns that are available to companies that perform well and those that perform poorly (assuming the efficiency assessment and the calibration of incentive rewards have been properly carried out).

194 Moreover, we can see some merit in what Ofgem describes as 'a proportionate regulatory approach' whereby the degree of regulatory scrutiny is dependent on a company's track record for planning and delivering efficiently, with those companies that have established a good track record being able to secure a small premium on their allowed return of the order of 5-10 bp. Similarly, were Ofgem to develop a menu approach whereby companies could choose between options with respect to the balance of risk and reward provided in a settlement, clearly there would need to be correspondingly differentiated allowed returns associated with those options. These possibilities merit further consideration by Ofgem.

> **Question 7:** Are there other issues with the current approach that we should be considering?

195 There are no other issues with respect to the current approach that we wish to raise with Ofgem.

Chapter 5: Embedding our financing duty in a new regulatory framework

> **Question 1:** Do you have views on our suggested straw men principles for embedding our financing duty in a new regulatory framework?

196 We agree that the allowed return should be set at a level to reflect the riskiness of the network company's revenue and cost streams, based on that company operating in an economic and efficient manner and assuming a notional capital structure. We do not agree that the allowed returns should vary across companies within a given sector depending upon the risk profile of the particular company with respect to factors such as required investment or topography, but we do agree that it might vary by reference to the incentive structure of the regulatory regime and by reference to the risk profile of the particular company if risk-reward options are made available.

197 We do not agree that the depreciation allowance should be set to reflect the average expected useful life of physical assets of the licensee. For the reasons set out in our answers to questions 1, 3 and 4 we think it is more helpful for Ofgem to think in terms of the appropriate payment terms and the need to send appropriate signals to users. This would lead to a conclusion that repayment periods should be considerably shorter than technical lives.

198 We agree that Ofgem should continue to assess the expected financial health of an efficient network company under a proposed price control and that Ofgem should specify the test that will be used. We understand that Ofgem may wish to bring to bear tests other than those used by the credit-rating agencies and that Ofgem should rule out the use of essentially arbitrary adjustments (e.g. accelerated depreciation to the price controls to ensure financeability). However, Ofgem's approach must reflect the reality of the financial markets, which attribute considerable significance to the credit-rating agencies, and it would be inappropriate for Ofgem to disregard that reality. Paragraphs 5.8 to 5.12 of the *Embedding financeability consultation paper* are a matter of serious concern to us. Ofgem begins with the statement:

> 'If both the allowed return and depreciation allowance are set appropriately, the notional company should be financeable.'

It goes on to recognise, however, that the actual network company may not be financeable even if these parameters are set appropriately. Ofgem sets out a number of reasons why this might be:

- the company has chosen a significantly different financial structure;
- the company is operating inefficiently; and/or
- the company faces a mismatch in its cash flows, which means that its available revenues fall short of the necessary financing costs at a particular point in time, though not on average over time.

199 This is fair enough, but Ofgem concludes that where there is a mismatch in cash flows that indicate that the ratios fall short of those required by the rating agencies to support investment-grade ratings in the short term (but not on average over time):

> ‘Given the negligible revenue risk faced by regulated networks and the limited cost risk, this should not raise financeability issues.’

This declaration is at variance with the realities of the financial markets.

200 The debt markets are certainly influenced by the credit-rating agencies’ assessment of the creditworthiness of companies. It cannot be expected that providers of debt finance will simply disregard the assessment of the credit-rating agencies. Indeed, we understand from the *Ring fence consultation* that Ofgem sees merit in continuing to require that licensees should maintain an investment-grade status. It follows, therefore, that the only solution if a company is to maintain an investment-grade rating whilst its cash flows are stretched would be for the company to secure a further injection of equity. Here Ofgem’s thinking becomes disconnected from reality. We are aware of no equity investors who are indifferent to cash flows in the short to medium term and we say this from the perspective of a company that is owned by an investor that is famed for its long-term approach to the holding of equity investments.

201 Ofgem’s suggestion that network businesses should seek out a different class of owner that attaches more value to longer-term income streams has led us to consider whether there are any examples of industries where high growth characteristics are accompanied by a low WACC. The results from our preliminary enquiries using equity betas in a range of sectors suggests not. Sectors with equity betas similar to those seen in utilities include forestry, tobacco, non-durable household products, pharmaceuticals and reinsurance. All these are income rather than growth sectors. The growth sectors have relatively high equity betas and by implication relatively high WACCs.

202 The gas networks in Northern Ireland also provide a helpful insight. The gas transmission activity required an initial equity and debt investment, with revenue streams generated later. In the associated price controls the nominal cost of equity was set at 15% for the 25 years of the licence. This suggests that, in order to attract initial investment in the business, a relatively high WACC had to be set.[30]

203 Moreover, investors such as pension funds already will have stakes in various electricity distribution businesses, particularly through debt holdings. They can also already choose to become equity investors if they wish, and have actively done so in a range of industries (e.g. Ontario Teachers' Pension Plan recently bought the equity of Camelot).

204 One of the benefits of shorter regulatory depreciation periods is that faster cash flows increase the dividend capacity of the licensee. This has the beneficial effect that it encourages regulators to set a realistic cost of capital at each review because only then will investors be encouraged to re-invest their earnings in the network (as indeed CE's parent company has done since it acquired NEDL and YEDL).

205 In summary, therefore, we recommend that Ofgem:

- retains a speed of money that ensures that investments are paid for at a faster rate than is implied by their technical lives; and
- recognises that it must continue to ensure that a licensee will be able to maintain its investment-grade credit rating.

> **Question 2:** Are there other issues and models that we should be considering for our summer 2010 recommendations?

206 We have no other issues that we wish to bring to Ofgem's attention for consideration in the summer 2010 recommendations.

Chapter 6 Further issues and next steps

> **Question 1:** Do you have views on the issues that we will need to consider as we develop the detail on financial issues in a new regulatory framework for our summer 2010 recommendations?

[30] Although the high cost of equity was partially accounted for by a relatively high assumed gearing of 72.5%, an additional allowance on the cost of debt (market rates for comparable utilities +0.38%) was also made for this.

207 At paragraph 6.1 and 6.2 of the *Embedding financeability consultation paper* Ofgem sets out the issues that it will need to consider in depth for its summer 2010 recommendations to the Authority. We have no further observations to make about additional issues that should be considered by the Authority and our views with respect to the issues listed by Ofgem are set out in the foregoing paragraphs of this response.

OTHER OBSERVATIONS ARISING FROM THE CONSULTATION PAPERS

208 As far as possible we have tried to incorporate our comments on the *Supporting papers* within the answers that we have set out above to the questions contained in the *Principal Consultations*. However, for completeness we set out below some further observations on the *Incentivising efficient delivery consultation paper* and the *Simplicity of the framework consultation paper*.

Incentivising efficient delivery supporting paper

209 Paragraph 1.3 of the *Incentivising efficient delivery supporting paper* states that a new regulatory framework would encourage energy network companies to:

- play a fuller role in facilitating delivery of a sustainable energy sector; and
- deliver at value for money for existing and future customers.

These are described as the ‘desired outcomes’ of the future regulatory framework.

210 Although we have taken issue with many of the themes running through the *Consultation papers* we recognise that meeting the desired outcomes of the future regulatory framework will require some changes to the structure of incentives that has been developed over the last twenty years. During the two decades since privatisation the emphasis has been on cost control with a ‘demand-focused’ approach to the running of the network. Investment ahead of need has been, for good reasons, discouraged and minimised. This success has delivered the benefits that it was intended to and it has driven real price reductions for customers without detriment to levels of service. In terms of innovation, the focus has been on bringing improved asset-management techniques to bear to extract better performance from assets without over-engineering.

211 With the changing priorities driven by the move to a lower-carbon economy, and in particular a lower-carbon energy sector, attitudes and thinking need to be refreshed so that the innovative impulse is directed towards the new priorities. Changes to the incentive structure, including packages like the LCNF introduced at DPCR5, are necessary to complement the existing features of the RPI-X system. There is no reason

to suppose that network companies are inherently less able to innovate than other sectors. If the incentives are present the innovation will follow.

212 At paragraph 2.6 of the *Incentivising efficient delivery supporting paper* Ofgem lists the potential benefits of an outcomes-led approach. We endorse Ofgem's view: the list of benefits seems to us to be sensible and desirable. However, we see no evidence that the 'stakeholder engagement' that Ofgem asserts has led it to these conclusions has taken any account of the views of one set of stakeholders, namely the investors in the network companies. Were Ofgem to consult with this group, we expect it would find that the investors would be interested in the potential reward that they might reap from the innovation risk that they would be expected to take. Their future revenue streams need to be clear (to enable them to make informed decisions) as well as conditional (in that they secure the rewards only if they are successful). Just as customers need to have a clear view of what they are getting for their money, so investors ought to have a clear view of what they are getting for what they contribute. Moreover, the itemised potential benefits of an outcomes-led approach are, in our view, potentially features of the current RPI-X system in any case. The work done at DPCR5 by Ofgem and companies in the development of outputs has made substantial progress in this regard and those customers who wish to inform themselves in the debate can find in the DPCR5 *Final proposals* an accessible and well developed analysis of what they are getting for their money.

213 Although Ofgem has usefully set out the potential advantages of an outcomes-led approach, we have to recognise that the progress towards innovation in the form of speculative investment is no more likely to occur under an outputs-led approach (as pioneered at DPCR5) than it was under previous iterations of the RPI-X system of regulation.

214 Ofgem appears to recognise this at paragraph 2.9 of the *Incentivising efficient delivery supporting paper*, where it states that 'the outputs that currently exist may not sufficiently capture what is needed to deliver our desired outcomes.' Ofgem goes on to state that the new regulatory framework, if implemented, would be focused on delivery of outputs, with a clear link between the revenue that a network company is allowed to earn and the delivery of those outputs.

215 However, the success that we have had in the development of outputs at DPCR5 may have obscured an important point. The most important outcomes that a network has to secure may not necessarily be things that are captured in the DPCR5 outputs regime and they may not necessarily be things that customers or users actively seek or reveal through a stakeholder engagement process. For example, the Electricity Safety, Quality and Continuity Regulations (ESQCR) make statutory provision for a number of

‘outcomes’ that electricity distributors must achieve. Some of these are acknowledged (but no more than that) by Ofgem in the *Incentivising efficient delivery supporting paper*. Safety is the most obvious example, but there are other important categories that drive significant investment that is non-discretionary. Moreover, there is a very important category of output that we have to invest to deliver that is required by law but which, if we are successful, will never be visible to customers and is not measurable in the conventional way (i.e. by counting the number of times it occurs). We have to invest to prevent the *likelihood* of, say, a widespread power outage ever occurring. This drives us to invest large sums of money to ensure that part of the network moves from a situation where there is a *relatively* high (but *absolutely* very low) probability of widespread outage to a situation where there is relatively low (and also absolutely still very low) probability of that occurrence. Capturing these kinds of outputs within the regulatory incentive mechanism is a considerable challenge for the proposed new approach. We do not believe that this has been sufficiently recognised in the *Consultation papers*.

216 At paragraph 2.17 of the *Incentivising efficient delivery supporting paper*, Ofgem recognises that the licensee’s statutory obligations would need to be captured in the output measures. Ofgem usefully cites the health and safety requirements on gas networks set out by the Health and Safety Executive (HSE) that determine the safety and reliability aspects of delivery of gas network services. We need to recognise, however, that such obligations are often framed in terms of a requirement to do something up to the point that is ‘reasonably practicable’. In such cases the response to the obligation involves the measurement (or modelling) of risks and judgements on tolerability. This is not particularly easy to capture in a set of objective outputs on which rewards or penalties might turn. Companies themselves manage to internalise these issues when they report to their directors on how they are complying with their legal duties. They may even have found ways to quantify their assessment of the relative risks inherent in different approaches to meeting these obligations. Regulatory rewards and penalties demand a different degree of auditability. The challenge is considerable and it relates to a very large component of the overall investment programme. Ofgem must be alert to the risk that an outputs regime could lead to the tail wagging the dog because it will focus on what can be measured rather than what is required.

217 We note (in paragraph 2.17 of the *Incentivising efficient delivery supporting paper*) that Ofgem is considering encouraging network companies to work proactively with others to develop cross-sectoral solutions and that, in this context, it may be appropriate to use some outputs that relate to aspects of delivery that are partly outside the control of the network company. This sounds quite risky and would be acceptable only if the rewards were commensurate with the risks being undertaken.

218 Paragraph 2.17 of the *Incentivising efficient delivery supporting paper* also refers to the use of leading and lagging measures, where leading measures would provide information on risks to future delivery, whereas lagging measures would provide information on delivery performance, after output targets have been met (or not). Ofgem then makes reference to the loading and health indicators developed at DPCR5. These indicators can be said to be leading indicators only because we established the current level of performance and then made a forecast of what the measured level will be in five years' time. After five years have elapsed the measure will be a factual recording of actual measured and manifest performance. This is not quite the same thing as a 'leading indicator' of network performance. The discourse seems to be confusing outputs measured by counting failures directly (often referred to by Ofgem as lagging) and outputs measured by an assessment of the likelihood of something happening (often referred to as leading). The confusion arises because conversations about probabilities are usually focused on the future, whereas conversations about levels of actual observed asset failures are usually focused on the present or the past. However, leading indicators are actually things we can measure *now* that give clues about the likely *future* value of something we can validate via a lagging measure only when we get there. For example, the amount of rust on a pylon might be a leading indicator of the future level of performance, but that performance can be measured as observable consequence or as estimation of risk. The key point is that both of these types of measure can be 'current' or 'forecast', which is different from 'lagging' or 'leading'. This is important because if investment to address future performance and risks is being made then the measures used to assess it must be understood. Otherwise there is a danger that Ofgem may make decisions about proposed investment on the basis of a misunderstanding of its benefit in future.

219 Also at paragraph 2.17 of the *Incentivising efficient delivery supporting paper* Ofgem refers to the possibility that network companies may also develop 'voluntary services level agreement with their consumers' with delivery linked to specific project milestones in some cases. We are not sure how this could be applied in the case of an electricity distributor unless it referred to the provision of a particular connection that was specific to that user. Since we cannot see how this would work we are doubtful about this tentative proposal.

220 Paragraph 2.20 of the *Incentivising efficient delivery supporting paper* makes reference to the requirements set by other parties, citing the Health and Safety Executive, and the statutory obligations of the licence of a network operator. It is reassuring to see that Ofgem notes these obligations, but in our view they are significantly underplayed throughout the document. The obligations placed on us by law drive more than 80% of our investment programme. The *Incentivising efficient delivery supporting paper* seems to treat these as an added extra that must not be forgotten, rather than as the

fundamental driver of our investment. Moreover, these requirements are often defined in terms that themselves require further judgement. Instances where the HSE place specific obligations on companies (e.g. to replace all cast iron gas mains by a certain date) are actually quite rare. It is more common for companies to be required to take 'all reasonable steps' or to do all that is 'reasonably practicable' to guard against a particular risk. Developing an outputs regime that captures these subjective considerations is not straightforward. We have developed ways of assessing current and future risks which could be used in a framework like the one being proposed and we would suggest that Ofgem needs to work collaboratively with network operators to utilise this.

221 In paragraph 3.2 of the *Incentivising efficient delivery supporting paper* Ofgem invites comments on the appropriate length of the business plan period that should be adopted. We would suggest a rolling 10-year time horizon. It is consistent with the approach that we take in the running of our business and it would give Ofgem a reasonable picture of the short-to-medium-term investment horizon. However, we do not necessarily think that any formal commitment to a ten year price control would need to be implied by such a move. We explained this point more fully in paragraph 36 above.

222 On page 24 of the *Incentivising efficient delivery supporting paper* Ofgem provides a table of indicative examples of how differential treatment might work. We do not disagree with the tabulation provided here, but we observe that there is a highly discretionary feel to much of Ofgem's approach in the *Consultation papers*. Ofgem will no doubt wish to ensure that the judgements that it makes are robust to challenge. Again this is not straightforward and the paper does not give very much explanation of how such a robust decision would be reached. Before proceeding in this direction, we think that Ofgem would need to consult on a very clear framework and method for appraising performance as this seems to us to be an example of a worthy concept that, in its high level form, is very difficult to disagree with in principle. The difficulty might well arise when the judgements are to be made and winners and losers are named. It would not be the first time that a grand idea in principle failed to gain acceptance as a result of problems in the practicality of its implementation.

223 At paragraph 5.41 of the *Incentivising efficient delivery supporting paper* Ofgem makes reference to developing its approach to total-cost benchmarking when assessing relative efficiency. We agree that this is necessary and indeed it is long overdue in the conduct of price control reviews. Separate treatment of different categories of costs can give rise to distortions and incentives. The move towards more equal incentives at DPCR5 was an important step. A total-cost approach to benchmarking of efficiency is necessary to complete this policy improvement. Even so, even when the benchmarking relates to total costs many of the problems of benchmarking remain: the data must be

consistent, the cost drivers must be right and the efficient comparators must be worthy of emulation.

Simplicity of the Framework Supporting Paper

224 The *Simplicity of the framework supporting paper* addresses a concern that Ofgem has previously articulated, namely that 'the framework has become too complex'. Simplicity may be attractive and it may make it easier for people to 'respond to consultation and effectively engage in the process', but Ofgem should not give simplicity too elevated a position in the considerations that guide it in the design of a regulatory regime. Complexity that is necessary to achieve a sound purpose is to be preferred to simplicity that gives rise to perverse incentives and results in undue rewards or penalties. However, where the complexity itself is the cause of unintended consequences, simplicity that achieves the purpose is obviously to be preferred.

225 At this and other points the *Consultation papers* appear to prefer a world in which regulation is simple and where the processes and the outcomes would be enriched by the participation of those who are currently excluded by the unnecessarily arcane features that have developed over the years. We think such a model is neither realistic nor desirable and we would suggest that Ofgem should accept that regulation is sometimes necessarily complex and that it is an activity that best serves its purpose if those charged with the responsibility do not pursue an agenda of simplification for its own sake. Perhaps this is why the *Simplicity of the framework supporting paper* is mainly about dealing with the issues that arise from the further complication of the regulatory framework that is implicit in much of the RPI-X@20 proposals.

CONCLUSIONS

226 It will be clear from the foregoing paragraphs that CE is supportive of many of the changes that Ofgem is seeking to bring about under the RPI-X@20 project. Some of these have already been introduced for electricity distribution networks at DPCR5. In particular we would like to see the regime continue to develop so that the business plans of the licensee play a larger part in the regulatory process. In our view, even if all the changes that Ofgem is contemplating in its emerging thinking were to be made, we would still be left with a system of regulation that we would all recognise as being of the RPI-X type. That form of regulation has served society well in the past and we believe that it can continue to do so in the future. Accordingly, we do not accept Ofgem's statement that 'RPI-X … is no longer fit for purpose' and regard this as an unhelpful over-simplification that has the potential to mislead.

227 Having said that we support many aspects of the emerging thinking, we must also say that the documents are a cause of great concern to us.

228 Throughout this response to the *Consultation papers* we have stressed the profundity of the changes that Ofgem is proposing or contemplating. On one level we could look upon these changes as a set of disparate changes to the current mechanism each of which we might either support or oppose. However, taken together with the changes proposed in the *Ring Fence consultation*, we see a unifying theme to the reforms that is, if anything, more profound even than Ofgem has signalled in the *Consultation papers*. The common thread and the underlying rationale that informs the proposals is a fundamental change to the nature of the regulatory settlement that runs deeper than the forms of the mechanisms that constitute the RPI-X system of regulation. The privatisation settlement that was based on a profit-seeking company with entrenched property rights acting under the supervision of a regulator with a public-interest remit and with limited discretion would be significantly rewritten were Ofgem to bring about the changes that it proposes in the *Consultation papers*.

229 To be clear, we see no reason why Ofgem should not consult about making changes to the forms and mechanics of the existing regulatory formulae and, whether or not we favour a specific proposal for, say, more stakeholder engagement, equalised incentives or even financeability, we cannot object to the principle that Ofgem might think it appropriate to consult about making such changes. But the *Consultation papers* and the associated papers go further than this in that they contemplate changes to matters such as the composition of the board of directors of the licensee (designed to diminish the power of the controlling shareholder), the revocation terms of the licence (where Ofgem suggests that it may seek a power to make it easier to deprive the shareholders of their effective right to use their own assets), and the introduction of a third-party right of appeal (where Ofgem supposes that it can circumvent the process that has been laid down by Parliament for the modification of licences). In sum the underlying theme of the proposals is one that is detrimental to the property rights of the licence holders and that would increase the degree of discretion in the regulatory regime. We do not believe that such changes would be in the public interest. To the extent that these aspects of the emerging thinking survive this round of consultation, Ofgem will find us to be very strongly and actively opposed. That opposition will not diminish our correspondingly strong and active support for the important developments that are being contemplated that we believe are well within Ofgem's remit and that are in the long-term interests of all stakeholders.