

Hannah Nixon
Ofgem
9 Millbank
London
SW1P 3GE

9th April 2010

Legal & Regulatory

Lakeside West
30 The Causeway
Staines
Middlesex
TW18 3BY

t: 01784 874 000

f: 01784 878 719

Dear Hannah

RPI-X@20 review: Consultations on Emerging Thinking, Financeability and Third Party Right to Challenge Price Control Decisions

1. This is the Centrica response to all three consultations and is on behalf of the Centrica group of companies excluding Centrica Storage. We also attach a report we have commissioned from CEPA on the issue of the third party right to challenge final price control decisions. Neither this response, nor the appended report are confidential, and we are happy for these to be placed on the Ofgem website.

Executive summary

- The price control process is no longer fit for purpose
2. Suppliers are increasingly important stakeholders of the networks. Networks provide the route to market for energy suppliers, and when network service is interrupted it is suppliers such as British Gas who are called by customers to provide information on when their service will be resumed. The advent of smart meters, and the development of an energy services market to serve households and businesses, also means that energy suppliers will increasingly have better information on the future demands that consumers will be placing on energy networks. This will increase the demand for suppliers and networks to work more closely together.
 3. We spend over £2.2billion in network charges every year, accounting for around 28% of domestic customer electricity bills and 22% of domestic customer gas bills. We therefore pay, on behalf of our customers, a large proportion of the revenues that the network businesses receive.
 4. Price control processes are therefore hugely important to our business. Centrica devoted significant resource to Ofgem's most recent price control (EDPCR5). We provided independent information and analysis, as the only major supplier without network interests, and brought a customer and user perspective to the discussion. In the case of EDPCR5, Ofgem reached a price control settlement that struck the right balance between the investment requirements of the networks and value for money for customers. However price controls remain essentially a bilateral negotiation between the networks and Ofgem. Information continues to be shared between the networks and Ofgem in a way that is not accessible to external stakeholders. Since customers and suppliers have no formal role in the decision-making, it is perhaps not surprising that this is the case.

5. If the RPI-X@20 Review is to be a success, it must change this culture. The only way to do this effectively is to give a formal role in the process to suppliers and customers, so that networks have an incentive to engage with them during the process. If Ofgem does not deliver this reform, we will remain with a price control process that is no longer fit for purpose. And the opportunity for energy regulation to be modernised in the way it has been in other sectors (such as airlines, where a right of appeal now exists), will have been missed. Against this background Centrica would have to consider how much it invests in engagement in future price controls.
 - Extending the right to challenge price controls to third parties should now be a priority
6. Ofgem now has an opportunity, through the Review, to address this issue. We support Ofgem's recognition that increasing engagement by consumer interests in price controls should be a key objective. However, the only way this can be achieved is to change the dynamics of price controls, by introducing a clear route by which third parties acting in the consumer interest are able to challenge price control settlements. Without this change, the incentive for stakeholders such as suppliers and consumer lobby groups to devote time and resource to price controls will continue to be weak.
7. As network charges increase year-on-year, and as the policy trade-offs Ofgem will need to make in price controls become more complex, future price controls risk not having the accountability and legitimacy they need given the financial demands that network costs place on suppliers and customers. The burden on Ofgem to make the right judgements is huge and if they get it wrong, customers and suppliers have no right of challenge. This could be addressed by extending the formal right of appeal to third parties.
8. This would also lessen the need for Ofgem to specify detailed consultation processes for price controls. Instead, the onus would be shifted onto networks to ensure they engage with their stakeholders effectively, so as to manage the risk of challenge. Just as the networks need stability and clarity over their future revenues, so British Gas needs to know what its network cost bill will be to plan our pricing to customers. Therefore we have no more interest in protracted regulatory processes than the networks, and we think that the appeal mechanism should include safeguards to avoid frivolous appeals.
9. Extending the route to challenge would be more consistent with the closer relationship that suppliers and networks will have in the future, with the advent of smart meters and growth of the energy services market.
10. Ofgem has acknowledged that third parties are already able to ask Ofgem for price control settlements to be referred to the Competition Commission. However, at the moment it is unclear how Ofgem would assess such a request. In contrast, there is an expectation that Ofgem will always refer price control settlements to the Competition Commission when requested to do so by the regulated networks.
11. Ofgem should provide clear guidance on how it would assess any requests it receives from third parties to refer price control settlements to the Competition Commission for consumer interest reasons. This would remove existing uncertainty over how such requests would be treated in future controls. It would also provide necessary clarity over the referral process. If defined carefully, this could create an effective route to challenge for third parties.
12. An alternative way of introducing a right to appeal would be through legislation. This would be more difficult to introduce in the remit of the Review, however would allow alternative models for the appeal process to be considered (including direct referral to the Competition Commission). We also ask Ofgem to explore the feasibility of new legislation as an alternative route to delivering an effective third party right to challenge.

- Network financing principles must be clearer, and output measures introduced with caution
13. We support proposals to address some of the arbitrary adjustments that have been made to the way in which networks have been financed in past controls. Accelerated depreciation in particular is one such adjustment that unfairly penalises current consumers over future consumers. We support the development of a framework that will help to avoid such adjustments in future, and promote the development of effective financing policy in future controls.
 14. Ofgem should also be clear that the risk of administration remains a credible threat for networks. This is the best way to ensure that networks place sufficient focus on ensuring that they finance their activities prudently.
 15. While we support the development of an output-based regulatory regime, we do not believe significant funding should be attached to output measures until these have been shown to be robust. This will mitigate the risk that networks will make large windfall gains or losses in future controls.

Overview of our response

A step change in stakeholder engagement in price controls is essential

16. We support Ofgem's proposals to increase the engagement of stakeholders in the regulatory framework. However, the need to cater for a wide range of different stakeholder interests means Ofgem's proposals are unlikely to lead to engagement by networks at a level of detail that suppliers would find useful.
17. Rather than designing lengthy ex ante processes with an objective of meeting the needs of many different stakeholders, effective engagement will instead be best encouraged by giving stakeholders a clear route to challenge a price control settlement if they believe it is not in the interests of consumers. This places the responsibility for engagement on networks, as the best way of managing the risk of challenge.
18. A clear route to challenge a price control outcome would give customer lobby groups and stakeholders a much clearer reason to become involved in price controls. Without any escalation option, it is harder to justify the time and resources needed to become involved in the detail of price controls.
19. This change would also improve the robustness of the regulatory process and subsequent regulatory decisions, with networks engaging all stakeholders at an earlier stage in the price control. It may also inform future decision making, as the outcome of any challenge that went to the Competition Commission would provide valuable information for Ofgem that could be used in future price control decisions.
20. The lack of an appeal of any Ofgem price control since 1997 suggests the balance of interests under the current arrangements is not appropriate. This concern is compounded by the evidence from calculations of RORE that suggest that for EDPCR4 a number of DNOs have made very significant out-performance gains while also being shown to be poor performers with regard to customer service and cost efficiency.

The risks of giving third parties a right to challenge price controls have been overstated

21. Safeguards can be designed that will mitigate all of the risks raised by networks in the context of a broader right to challenge price control settlements. The risk of "frivolous" challenges, or challenges that are not in the interests of customers can be mitigated by specifying a role for a "gatekeeper." This party would make an initial assessment of challenges, rejecting those that fail to meet predefined criteria.

22. There would be also no detrimental impact on security of supply of a broader right to challenge. Suppliers have clear incentives to ensure that networks are sufficiently funded given they represent the only route to market for energy suppliers. Ensuring customers are well served by networks will also be critical in coming years as suppliers are focused on building customer confidence in the changes that smart meters will bring. Indeed, security of supply is likely to be improved, not lessened, by the increased engagement that a third party ability to challenge price control settlements on consumer interest grounds would deliver.
23. A third party right to challenge control settlements would not increase the level of uncertainty in the price control, so long as appropriate safeguards were put in place. Parties should be required to provide evidence of full engagement in the entire price control process before being able to raise a challenge. In the event a challenge progresses to the Competition Commission, uncertainty could be further reduced by introducing the price control as the assumed outcome of the review while the challenge is being progressed.

Ofgem has the power to introduce a third party right to challenge price controls

24. Ofgem has acknowledged that an effective route to challenge price control settlements for third parties can be achieved without the need for legislation. Just as networks currently ask Ofgem to refer a price control settlement to the Competition Commission if they do not believe it is in the interests of their shareholders, so stakeholders could ask Ofgem to refer a price control settlement to the Competition Commission if they do not believe it is in the interests of consumers. Ofgem has already confirmed this is possible within the existing regulatory framework.
25. To be an effective route to challenge, Ofgem would need to provide guidance on how it would assess such requests. This would need to set out who could raise a challenge, the timescale and process a challenge would have to follow, the information that would need to be provided as part of the challenge, how such a challenge would be assessed by Ofgem and how costs would be recovered. Such guidance is also necessary to remove existing uncertainty over how such requests would be treated in future controls.
26. An alternative route to challenge price control settlements could be introduced through primary legislation. This may deliver a more robust model for a right of appeal, but is likely to be more difficult to introduce within the remit of the Review. We favour exploring both routes.

Improvements can be made to the way in which networks are financed

27. Network companies should be able to finance investments over a long period of time without the need for short-term "fixes." Arbitrary adjustments to regulatory revenues (e.g. accelerated depreciation) for financeability reasons should be discontinued. A clear set of principles to guide policy judgements on financeability and related policy issues for price controls would be useful. Such guidelines would prevent the adoption of arbitrary adjustments in the future.
28. The risk of administration should remain credible to ensure that networks make efficient financing decisions. This is the best way to ensure that networks place sufficient focus on ensuring that they finance their activities prudently. Where the investment grade credit rating of a network may be at risk, shareholders of networks should be as prepared to make an equity injection as shareholders of companies in competitive industries with comparable credit ratings. Networks should not always rely on customers to provide additional financing through higher charges.

29. Risks should only be allocated to networks where they are able to manage these more efficiently than consumers. The “headroom” approach in which networks receive a premium over the cost of capital is not the appropriate way of managing the uncertainty surrounding the cost of debt. We favour an “indexation” approach, where a (predictable) mechanism for adjustments to the cost of debt is introduced. The use of revenue drivers in incentives should also be analysed in more detail in future work on the financeability of networks, to ensure these deliver value for money for consumers.

Focus should be maintained on ensuring customers receive value for money from networks

30. We support proposals to encourage longer term business planning, and an increased focus on the delivery of output measures by networks. This will help networks focus directly on the aspects of service delivery that customers value, and make networks more accountable for the costs they incur. However, only limited financial rewards should be linked to output measures until the approach has been shown to work in practice (limiting the potential for significant windfall gains / losses).
31. While we believe the current regulatory framework has delivered well over the past 20 years, we accept some changes may be required to ensure it is capable of delivering the multiple aims of an energy system that meets targets for sustainability, maintains security of supply and yet is affordable for customers. For this reason, there are good arguments for additional change, such as the proposed measures to encourage innovation with specific regard to improving sustainability of energy networks.
32. We support the principle of competitive tendering, but only so long as this does not introduce significant delays to projects that could impact meeting emissions targets, or which are necessary for security of supply. Learning points from the OFTO process must also be fully reflected in any future tenders.
33. We set out our more detailed comments in the following sections:
- effective engagement with stakeholders;
 - financeability; and
 - innovative and efficient delivery.

Effective engagement

34. An effective price control requires the regulated energy networks to develop business plans that accurately reflect the needs of consumers, network users and Government. These stakeholders have very different consultation requirements, in terms of both issues to be addressed, and level of detail of engagement. In the most recent price control (EDPCR5), Ofgem made significant improvements in the way in which stakeholders can engage with the price control process. However there is a limit to which Ofgem initiatives can be effective in forcing networks to engage in greater consultation within the existing regulatory framework.
35. At present, networks have no real incentive to engage fully with their stakeholders, and tend to do so only after encouragement from Ofgem. Instead, networks continue to treat price controls as a bilateral process of negotiation with Ofgem. Important information that would be valuable to some stakeholders continues to be shared between the networks and Ofgem in a way that excludes external stakeholders.
36. The only way to change this culture would be to introduce a third party right to challenge price control settlements. At a stroke, this would mean networks would devote far more time and resource to stakeholder engagement, as this would be the most effective way of mitigating the risk of a challenge being raised. This culture change would also increase the likelihood of Ofgem’s proposals on enhanced engagement being a success.

Third party right to challenge price control settlements

37. In this section we set out:

- the benefits of a third party right to challenge price control settlements;
- how to mitigate the risk of a third party right to challenge; and
- how such a right could be introduced.

Benefits of a third party right to challenge price control settlements

38. The key benefit from giving stakeholders an effective way of challenging price control settlements would be to shift the balance of the price control. The process would change from one which is essentially a negotiated settlement between Ofgem and the regulated companies to one where consumers are fully engaged in the process from an early date. This would mean closer, earlier and deeper involvement in the regulatory process by all interested parties.
39. The increased engagement that this change would deliver would lead to an improvement in the robustness of the regulatory process and subsequent regulatory decisions. Networks would have a stronger incentive to ensure that all stakeholders were fully engaged from an early stage, mitigating the risk of price control decisions being made on the basis of incomplete information.
40. Giving stakeholders an ability to challenge price controls would also help inform future decision making. In the event that a price control decision was challenged by a stakeholder, then the outcome of the process would provide valuable information for Ofgem that could be used in future price control decisions. The regulatory process was originally established in such a way as to provide for learning through the appeals process. This seems to have been forgotten and appeals to the Competition Commission now seem to be viewed as a failure of the regulatory regime rather than an opportunity for difficult issues to be discussed and lessons learned for future determinations. Broadening the scope of who has the right to challenge control settlements would potentially bring back this original situation.
41. The lack of an appeal on any Ofgem price control since BG Transco in 1997 is a strong indication that the balance of interests in recent price controls has not been appropriate. Our concern about the inappropriate balance of the current arrangements is further compounded by the evidence from calculations of RORE that suggest that for EDPCR4 a number of DNOs have made very significant out performance gains while being shown to be poor performers with regard to customer service and cost efficiency.

Mitigating the risk of a third party right to challenge

42. A number of arguments have been made by networks against giving stakeholders other than networks a way of challenging price control outcomes. One such argument is that some stakeholders may contest price control outcomes for reasons other than consumer interest. We believe this risk can be mitigated by having a clear "gatekeeper" who assesses a challenge, and ensures it truly is in the customer interest before referring to the Competition Commission for full review.
43. A further argument made by networks opposing such a change is that stakeholders (particularly suppliers) have insufficient regard for security of supply, and therefore will not fully consider impact on security of supply when preparing a challenge. This is patently untrue. Networks provide the route to market for energy suppliers, and when network service is interrupted it is suppliers such as British Gas who are called by customers to provide information on when their service will be resumed. Building customer trust in a reliable and effective energy supply is also particularly important at a time of significant

change for the industry, and when suppliers are focused on building customer interest and confidence in their energy supply during the rollout of smart meters.

44. Suppliers also have a clear incentive in ensuring that network charges are relatively stable and predictable. Networks facing security of supply issues (increasing the risk of price control reopeners to provide additional funding) are unlikely to lead to network charges that are either stable or predictable. Suppliers therefore have every incentive to ensure networks are appropriately funded, and are able to maintain system security over the long term. Increased engagement driven by a broader route to challenge is actually more likely to improve security of supply, given this will increase the robustness of regulatory decision making.
45. A further concern raised by some parties is that a third party right to challenge control settlements may create an increased layer of uncertainty in the price control. However, we believe that this can be fully mitigated by the careful design of the challenge process (for example, by requiring a party raising a challenge to provide evidence of full engagement in the entire price control process, rather than raising challenges late in the day).
46. These potential risks should also be set against the fact that no network company has felt sufficiently challenged by a price control settlement in recent reviews to decide to make an appeal to the Competition Commission.
47. The CEPA report submitted as part of this response provides further details of safeguards that could be introduced to address concerns raised to date over the introduction of a broader right to challenge.

Introducing a third party right to challenge price control settlements

48. Ofgem has already recognised that, under the existing regulatory framework, third parties can ask Ofgem to refer price control settlements to the Competition Commission. It would therefore be possible for Ofgem to more formally recognise the way in which would assess such requests in future controls. This would require Ofgem to provide guidance on the way in which it would manage such challenges.
49. Such guidance will need to address issues such as:
 - **the scope of parties who are able to challenge.** All parties who can demonstrate they are acting in the interest of consumers should be able to ask Ofgem to refer a price control settlement to the Competition Commission.
 - **the timescale and process a challenge would have to follow.** We suggest that a challenge from a third party should be notified to Ofgem by the same date the network companies have to confirm whether they accept or reject the price control.
 - **the information that would need to be provided as part of the challenge.** Such information is likely to include the issues being challenged (i.e. all or part of the control), the principle reasons for challenge and why the party believed that the challenge was in consumers' interests.
 - **clarity over how Ofgem would assess a request, setting out how Ofgem would fulfil a "gatekeeper" role.** This should say how Ofgem would ensure its staff and/or Authority members involved in assessing a third party challenge would be able to take an objective view of the request to challenge. It should also set out what opportunity the third party would have to make its case, and to what extent Ofgem would provide reasons for rejecting any request to challenge.

- **how costs would be recovered.** Ofgem could require parties to provide an up-front commitment to pay costs if their appeal to the Competition Commission is unsuccessful, and provide evidence of availability of funds to do so.
50. An alternative way that a route to challenge price control settlements could be introduced would be through primary legislation. This would enable Ofgem to introduce a process which would be even more robust than that outlined above. However, given the need for legislation, we recognise this may be more difficult to introduce within the remit of the RPI-X@20 Review.
51. If new legislation was found to be a credible option, we would propose a model similar to the strawman outlined by Ofgem in the consultation document for the third party right of appeal. The key characteristics of this model would be:
- the need for a clear and strong “gatekeeper” to ensure frivolous appeals are rejected at an early stage. Without the need to work within the confines of the existing regulatory framework, we believe that the most suitable party to be gatekeeper is the Competition Commission itself (rather than Ofgem). This is because it has been shown to fulfil this role well in the context of the appeals mechanisms in energy codes, and would be able to take an objective view on issues raised in the challenge given its relative independence from the review process.
 - a broad range of parties should be allowed to challenge price control decisions, provided that the party could demonstrate that their interests are aligned with those of end consumers. The judgement of whether the grounds of an appeal were in the interests of end customers would need to be undertaken by the body appointed as “gatekeeper” (i.e. the Competition Commission).
 - a check to ensure that parties raising an appeal have been effectively engaged with Ofgem and the network companies during the price control process. This could be included as part of the “gatekeeper”, and at its most basic constitute a check that the appellant has responded to key consultations throughout the price control process.
 - the clear awarding of costs where appeals are rejected. Specifically, the risk of an unsuccessful challenge should be coupled with the risk of not only having to pay for the ones own costs of the appeal, but also for a reasonable amount of the opposing parties costs. The Competition Commission could award a proportion of costs where only a part of the appeal was upheld.
 - the new price control should be introduced as the default option while the appeal is heard. This would provide certainty to networks, and minimise the risk of any negative impact on investment while the price control was being undertaken. This would also ensure that Ofgem’s proposals were considered to be appropriate until such time as the appeal body found otherwise.
 - challenges to price control decisions should be capable of being either “single issues” or on the full price control. In practice, we think it difficult to envisage a successful appeal being lodged on a single issue (given the interrelated nature of price control decisions). However, we consider that there could be merit from an efficiency point of view in considering the option that an issue could be considered in isolation.
52. Further details of this model can be found in the attached paper on third party right of appeal.

Engagement process

53. The RPI-X@20 Review has set out a wide range of different alternatives for the way that the regulatory framework could evolve to promote more effective engagement between

networks and stakeholders. Each of the different combinations of models would (to varying extents) encourage greater involvement of stakeholders in the review process.

54. On balance, we think the "enhanced engagement" model proposed by Ofgem will achieve this most effectively. We agree, particularly for distribution, that it is not appropriate for stakeholders to negotiate elements of the price control with networks in isolation, and that Ofgem has a critical role as overall decision maker. This should mean that taking the price control as a whole, decisions will be consistent and in the overall best interests of customers.
55. However, we believe that the model may need to be applied differently to the transmission and distribution sectors, given fundamental differences in the nature and level of involvement of stakeholders in these two sectors.
56. Transmission has a relatively narrow range of generally very well informed stakeholders. It is therefore appropriate for Ofgem to attach greater weight when setting price controls to the outcome of the industry engagement process than at the distribution level. Models of industry engagement such as the Electricity Network Strategy Group (ENSG), and the Operations Forum are good examples of models which networks can use to better understand the needs of consumers, users and Government. However, it is important that Ofgem is very clear at the start of any such industry engagement how it will take account of the process outcomes.
57. In contrast, the distribution sectors in gas and electricity have a more disparate range of stakeholders, sometimes with relatively narrow or specialist interests. For this sector, groups such as the ENSG may be less appropriate (or need to be adapted significantly), and there is likely to be a greater need for Ofgem to ensure that the needs of stakeholders are properly represented. Decision making must therefore be as transparent as possible.
58. In EDPCR5, there was a marked improvement in transparency in some respects, particularly in the way in which the efficiency of the network businesses was benchmarked. However, some issues remained, such as significant adjustments to opex and capex allowances between Initial and Final proposals on which stakeholders had no or limited opportunity to comment.
59. Where Ofgem assigns a high weighting to the views of stakeholders (such as in transmission), then there may be instances where there is a need for investment ahead of clear user commitment. We recognise the need for such "anticipatory investment", and the concept of funding investment ahead of firm commitments from all potential users. However, it is also important to ensure that customers receive value for money from such investments, and that network remuneration reflects the risk of such investments. Network business should not be rewarded with higher returns for such investments where the risk of investment is not, in practice, materially higher. Merely because an investment is anticipatory does not make it higher risk or indeed more at risk of stranding.
60. To avoid increased regulatory risk, we agree that the Government should not have a decision making role. Instead, it is more appropriate for Government to adopt the role as a "guiding hand" in price control processes, clarifying energy policy (particularly at key decision points in price controls). However, when Government does make interjections in price controls, it is important that these are unambiguous, particularly when clarifying energy policy objectives.

Financeability

61. A critical issue for consumers is ensuring that settlements deliver sufficient financial stability for the networks to finance their activities over the price control. As the

consultation document acknowledges, network companies should be able to finance investments without the need for short term “fixes” (e.g. for cash flow reasons). This is because regulated networks have a transparent Regulatory Asset Base (RAB), and the regulatory certainty that an independent regulator brings. We therefore fully support Ofgem’s proposal to remove short-term adjustments to network revenues.

62. We fully agree that setting out a clear and transparent set of principles to guide judgements on financeability and related policy issues for price controls would be useful. Such guidelines would prevent the adoption of arbitrary adjustments in the future, and instead make clear that shareholders have to take responsibility for ensuring that network companies maintain investment grade credit ratings, if necessary through equity injections.
63. The application of such guidelines to existing arrangements would mean unwinding a number of existing imperfections in the arrangements. Unwinding the policy of “accelerated depreciation” would entail depreciating all assets on the basis of average useful lives for all existing and new assets. To ensure that current customers do not continue to pay an unreasonably high proportion of the costs of existing assets we would support introducing this revised approach as soon as possible.
64. Ofgem’s financing principles should also be clear that the risk of administration should remain a credible threat for networks. This is the best way to ensure that networks place sufficient focus on ensuring that they finance their activities prudently. Where the investment grade credit rating of a network may be at risk, networks should be as prepared to make an equity injection as companies in competitive industries with comparable credit ratings. Networks should not always rely on customers to provide additional financing through higher charges. Ofwat has adopted this approach in its latest price control review, and such a principle is also consistent with how businesses (such as ourselves who cannot rely on a regulated source of income) often have to finance expansion and investment. We would be happy to give Ofgem further details of our 2008 £2.2 billion rights issue as a case study (which we used to finance our investment in nuclear assets).
65. The use of revenue drivers in incentives should also be analysed in more detail in future work on the financeability of networks. We have concerns that in the current arrangements, there are some instances where networks could be rewarded where no appreciable benefit to consumers is delivered (e.g. the Canatxx issue at Fleetwood)¹. This is clearly inconsistent with delivering value for money for customers, therefore controls need to be introduced to ensure incentive revenues can be corrected where drivers of the revenue do not transpire.
66. We believe that risks should only be allocated to networks where they are able to manage these more efficiently than consumers. In terms of cost of capital, we believe the current “headroom” approach (in which networks receive a premium over the cost of capital at the time the price control is agreed) is not the most efficient way of managing the uncertainty surrounding the cost of debt. Instead we favour an “indexation” approach, where a (predictable) mechanism for adjustments to the cost of debt is introduced. This would

¹ In 2006 Canatxx bid for incremental capacity at Fleetwood in the Long-Term auctions. Under the existing PCR of the time National Grid receives SO incentive revenue for provision of this capacity for a period of 5 years. In the event, Canatxx have been unable to secure planning consents for their project. No investment by National Grid has taken place to provide this capacity apart from the assessment and specification work. As the capacity has now been offered in the short-term auctions, it is apparent that Canatxx have now defaulted on the credit arrangements, indicating their inability to take up the capacity in October 2010. National Grid will continue to receive SO incentive revenue on this non-existent capacity, the burden of which is now borne across all Shippers.

deliver better value for network users and end consumers, delivering significant annual savings while also reallocating risk more sensibly between networks and end customers.

67. We also believe that price control periods of longer than five years may be appropriate to provide increased certainty in some parts of the price control. For example, longer price control periods for some categories of investment could lead to significant reductions in financing costs. However, if these are introduced, we believe the case for indexation of the cost of debt grows stronger. We would be happy to work with Ofgem in coming months to develop models for the indexed cost of debt in more detail.

Innovative and efficient delivery by networks

68. It will be paramount to ensure that, in introducing any change to the regulatory framework, that care is taken to ensure that certainty and predictability is maintained. The current framework has shown it is capable of delivering impressive levels of investment over many years, and regulatory stability has been a significant factor in achieving this. It is essential that any change is introduced in a manner that does not threaten the timely delivery of investment, or the stability of the framework within which investment is encouraged.
69. We agree that a key focus of the RPI-X@20 Review should be to ensure that the regulatory framework delivers value for money for customers, and in this section set out our views on:
- how networks can be encouraged to deliver efficiently over the long term; and
 - the introduction of funding for innovation.

Delivering long term efficiency

70. We fully support the development of output based regulatory controls. Robust output measures are likely to lead to major long-term benefits to customers. In particular, by rewarding networks on the basis of the outputs they deliver, this should focus networks more directly on the aspects of service delivery that customers truly value. An output based regime should also make networks more accountable for the costs they incur, meaning customers can be more certain that they are getting value for money.
71. However, we would suggest that, as in EDPCR5, only limited financial rewards are initially offered under an output based regime until the approach has been shown to work in practice. This will limit the potential for windfall gains / losses for networks which may otherwise undermine such a regime. An approach in which, for a period of time, output based targets are set yet which are only monitored as opposed to being linked to financial rewards / penalties is therefore likely to deliver the best value to consumers in the long term.
72. We support proposals to encourage longer term business planning by the networks. In principle this should complement the development of more effective stakeholder engagement, and the introduction of a third party right to challenge price control settlements. However, it will be important to develop the details of what long term business planning would mean in practice.
73. Finally, we support the principle of competitive tendering, recognising this has the potential to deliver significant benefits for consumers. For example, tendering can reveal whether investments can be financed at a lower cost of capital and with less risk for customers than are offered by current network companies. We therefore support keeping this option open for further review.

74. However it is important to recognise that competitive tendering is only effective where there are numerous potential bidders competing for a range of tenders. The design of such mechanisms must also be informed by the many learning points that have emerged from the OFTO tenders. This will ensure that the benefits of future competitive tenders are balanced against the increased transaction costs that such tenders tend to involve. Finally, the use of tendering must not introduce delays to projects that could impact meeting emissions targets, or which are necessary for security of supply.

Innovation funds

75. The existing regulatory regime works well in delivering improvements in efficient delivery of network services over time. However, RPI-X was never intended to be a tool by which material improvements in innovation were delivered. The relative lack of success of the innovation incentive also suggests that incremental change is unlikely to deliver much by way of tangible innovation.
76. However, if Government targets for decarbonisation are to be met, there will need to be significant changes in the way we use electricity networks. The growth of microgeneration, and ultimately the widespread use of electric vehicles will present significant challenges for the networks. We therefore recognise there is a need for some form of mechanism to encourage the networks to examine how these changes will impact their systems.
77. To ensure value for money for customers, however, it will be important that the networks have clear guidelines and processes that mitigate the risk that such funding will be unproductive. It will also be important to ensure that the funds do not encroach on activities that are best delivered by the competitive wholesale and retail markets. Crowding out of investments and research that would otherwise be delivered by the free market would be a very poor outcome for customers.
78. Such funds must also have clear governance principles. These should include ensuring that funded projects are able to set out clear and measurable deliverables, including pre-defined milestones / success factors. This will allow funding to be withdrawn from failing projects. Projects should also only be granted funding if it can be demonstrated that there will be full transparency in the way that the project is conducted, and results shared.

Other issues

79. We remain very supportive of the concept of monitoring and calibrating controls through the use of the Return on Regulatory Equity (RORE). We believe this is a key way in which we can understand whether the price controls truly provide value for money for customers.
80. Given the importance of this measure, we would encourage Ofgem to publish annual analysis setting out a RORE assessment for each price control (compared to the allowed cost of capital). Aside from being an effective way of encouraging engagement of stakeholders on price control issues, this would also allow networks the opportunity to set out reasons why their RORE was significantly different to other networks in their industry (and in other sectors). Furthermore, Ofgem would be held to account regarding whether the price controls it had said had led to a reasonable balance between the interests of different stakeholders.

81. On benchmarking, we understand the reasons for moving to total cost benchmarking, and support this approach in principle. However, we would be concerned if Ofgem lost the benefits of separate opex and capex benchmarking as a consequence. In EDPCR5 for example, separate benchmarking of opex and capex revealed significant inefficiencies between the DNOs. As a minimum Ofgem should continue this benchmarking approach alongside total cost benchmarking at the next review, until it can demonstrate that its approach to total cost benchmarking will be more rigorous than the approach at EDPCR5. It would be a significant concern if the first time Ofgem has undertaken really robust comparative benchmarking of DNOs, it almost immediately abandoned the approach and adopted a new and unproven approach.

If you have any questions regarding this submission, or require any clarifications on the substance of our response, then please do contact me.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'PP: Philip Davies', with a large, stylized flourish extending from the end of the signature.

Philip Davies
Director, Regulatory Affairs