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RPI–X@20 Review
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Dear Hannah

Regulating Energy Networks for the Future: Ofgem's Consultation Papers on (i) RPI–X@20 Emerging Thinking, (ii) Third Party Right to Challenge and (iii) Embedding Financeability

Thank you for the opportunity to comment on Ofgem's emerging thinking on its RPI-X@20 project. Our detailed comments on the questions raised in the consultation are included in two attachments to this letter. The first of these responds to both the main consultation paper and the consultation on third-party rights of challenge, while the second deals with the parallel paper on financeability.

We are supportive of a number of the Emerging Thinking proposals, in particular enhanced stakeholder engagement and an increased focus on longer term outcomes. In our view, a number of the proposals are an evolution of the recently agreed DPCR5 framework, which we believe is sensible. However, there are three key areas where we have significant concerns with Ofgem's current thinking.

Firstly, we believe that Ofgem's proposals on financeability are simplistic and will, if implemented, actually raise financing costs, and hence the overall cost to customers.

We can understand why moving away from the cash ratios used by the credit rating agencies seems attractive, since this would enable Ofgem to lengthen the period of regulatory depreciation and hold down prices in the short term. However, the reality is that:

- Network companies will continue to need to raise finance on the debt markets and the providers of that finance will continue to rely on the information from the ratings agencies to inform their decisions and covenants.
- At the normal WACC, equity will only enter to support a growing RAV, not to support a short-term cash shortfall (where there would be a premium charged because of the regulatory risk involved in expecting Ofgem to achieve 'speed of money' neutrality over the long-term).
- Assuming that equity will always make up for any cash shortfalls would effectively circumvent Ofgem's legal duty to have regard to how NWOs can finance their functions.

At the same time, Ofgem also seems to recognise the value to consumers of NWOs maintaining investment grade credit ratings. In its recent consultation on the financial ring fence, Ofgem has sensibly proposed retaining the obligation for companies to maintain such ratings.

Ofgem has argued that its proposed approach would appeal to a certain class of investor. Notwithstanding our concern at the prospect of designing a price control framework that would principally appeal to a single class of investor, we do not accept that such investors are indifferent to the timing of their returns. As we have noted above, in funding more of the return over a longer period, Ofgem is exposing more of this future revenue to both political and regulatory risk. All investors are likely to require a premium for this. Consequently, if too much revenue is pushed into the future then the cost of capital is likely to increase, thereby raising costs for customers.

We also do not agree that lengthening the period of regulatory depreciation would better balance the interests of current and future consumers. Aggregate prices largely reflect sunk costs and therefore cannot be used to send price signals about forward-looking economic decisions. Furthermore, and perhaps more fundamentally, the existing DNO RAVs are only around 17% on average of the Modern Equivalent Asset Value (MEAV) of the assets being used by current customers (in other words, current customers are already being subsidised by past ones). Pushing future revenues out by lengthening regulatory depreciation would add to the under-pricing of current DNO services.

Secondly, we do not support the introduction of third-party rights of challenge to price control proposals. The principal risk with this proposal is that every review would automatically become subject to such challenge, so that the Competition Commission, rather than Ofgem, would effectively set all price controls. This would have the effect of destroying the network companies' existing right of appeal to another body. Such an outcome would also inevitably change Ofgem's behaviour, since it would not need to engage with difficult issues which it knew would have to be addressed by the Competition Commission anyway.

In addition, the process outlined in Ofgem's paper envisages that third parties seeking to challenge a review outcome would have to demonstrate how the outcome would be detrimental to consumers as whole, i.e. both existing and future consumers. However, existing customers or bodies representing them might not be the obvious representatives of the interests of this wider body of consumers. In our view, this distinction is important and raises a fundamental objection of principle to the proposal to introduce a right of third-party challenge.

Finally, we are concerned about Ofgem's ability to implement its proposals. The framework outlined in the paper, if implemented, will result in more bespoke company price reviews. This outcome is inevitable as the industry moves into a world where the outputs (and the associated risks) and the way in which those outputs are delivered (and the risks are managed) may vary across companies, because, for example:

- Outputs agreed with stakeholders vary between companies.

- Different, but valid, trade-offs between capex and opex delivery solutions have been made.

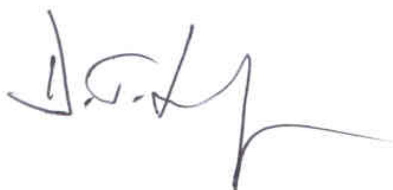
This means that Ofgem's tools and techniques for carrying out price controls will also need to adapt and develop significantly. The complexity of this work must not be underestimated and we would encourage Ofgem to begin developing its thinking on the detailed price control mechanics as soon as practicable after the completion of this project.

In our opinion, it would significantly damage the credibility of the future price control framework if Ofgem had to revert to a one-size-fits-all approach in assessing companies' future business plans.

Some of the proposals raised in the current consultations require significant work before acceptable proposals are developed. In these areas, we believe that it is essential for Ofgem to consult a number of times as proposals are developed and refined. We agree that this can be through working groups, or written consultation. However, we would urge Ofgem to publish a detailed timetable as to how this work will be done at the earliest opportunity.

If you have any queries about this response, please contact Paul Delamare, whose phone number is 07875 112317.

Yours sincerely



Denis Linford
Corporate Policy and Regulation Director

Appendix 1: EDF Energy's Detailed Response to the Main Consultation and Third Party Right to Challenge Papers

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

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

In principle, we agree that the stated high level outcomes are appropriate. It is unarguable that we should be looking to develop a sustainable energy sector at the lowest possible cost to customers. However, the key issue is what is meant by sustainable.

We broadly agree with the ideas, set out in Appendix 5, relating to the delivery of a sustainable energy sector. However, in our view, the role that energy networks play in supporting general economic development needs greater recognition, as an integral part of a company's role in facilitating sustainable economic development.

Ofgem recognises that in order for companies to operate efficiently in the long term they should anticipate the future requirements of customers. However, this is the case not only for future generation customers but also for future demand customers. It is equally important that the network is developed in a manner which enables the latter class of customers to connect to the network in the most economic fashion.

A further element that is missing is that a sustainable resource base is crucial to development of a sustainable sector. In particular, we believe that the regulatory framework must enable companies to invest in their workforce so that they (and their contractors) have sufficient manpower with the right skills to deliver the energy networks of the future. If this is not recognised then it is unlikely that the customers will get the optimum solutions, and hence value for money in the long term

Question 2: Do you agree that we need fundamental change to the existing RPI–X frameworks to ensure these outcomes are delivered?

We agree that the current regulatory framework needs to change to ensure that the energy networks of the future are fit for purpose. In our opinion, a number of elements do require fundamental review (for example, the role of stakeholders in the price control process). However, in other areas, such as financeability, Ofgem's proposals may actually hinder the delivery of the desired outcomes. We believe that fundamental change should only be introduced where it can be evidenced that this will deliver a better solution than simply evolving the current framework.

Ofgem's proposal to adopt a lighter regulatory touch is a necessary change. This change in regulatory approach is essential if companies are to be responsive to changing demands from stakeholders. However, our experience post-DPCR5 is that the regulatory desire to understand every activity at the micro level has increased, which is at odds with Ofgem's

emerging thinking on the future framework. In our opinion, a fundamental change in regulatory behaviour will be required if the benefits of changing the framework are to be delivered.

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?

Notwithstanding the concerns that we have highlighted in our response to Question 2, we believe that the concepts underpinning the proposed framework are the right ones for delivering the outcomes. We agree that, initially, an ex ante framework utilising a building block approach is the most appropriate option.

We note that Ofgem has discounted the use of ex post regulation. At this stage of the development of the framework, this is sensible. However, in the future we can see scenarios where ex post regulation might be viable. An example is the connections market, where, assuming competition develops, a move towards ex post regulation would be more appropriate. In fact a move to greater ex post regulation would be a logical conclusion of this process over the long term, as Ofgem becomes more confident that network companies are producing plans based on stakeholder needs and are delivering the required outcomes.

We also support a number of the elements of the proposed new framework. In particular, we are keen to see:

- A larger role for stakeholders
- Rewards for responding to and anticipating consumer needs
- The move to a longer term focus, and
- An agreed set of outputs that companies will deliver

There are, however, a number of the proposed elements that we believe will not deliver the required outcomes. Key amongst these is Ofgem's views on the financeability of network companies. We have responded in detail to Ofgem's separate consultation in the second appendix of this response.

We agree that Ofgem should reward companies based on the quality of their planning and the delivery of their outputs. However, it is not appropriate for Ofgem to reward companies based on its "perception" of these factors. Such an approach can never be transparent and hence does not meet the better regulation requirements. We accept that regulatory judgement will be part of the process, but we would expect Ofgem to set out the rationale supporting its judgement, and not just rely on perception.

We are also concerned that Ofgem's proposals on tendering may restrict our choice of contracting strategies. For example, one approach that we have employed is to enter into long-term alliances with a number of our key contractors. These long-term contracts provide a certainty of workload that is sufficient to enable the contractor to invest in developing its workforce to meet our ongoing requirements. However, it would be more difficult to offer

these types of contracts if elements of the required work programme were subject to tender by Ofgem or other third parties.

Network companies are subject to strong incentives to reduce costs and deliver outputs. They therefore already have strong incentives for efficient procurement. It is unclear why Ofgem would want to impose a particular form of procurement solution (i.e. competitive tendering) which may in fact be sub-optimal compared with other solutions. We believe that network companies should be free to determine their own resourcing strategies in the context of a framework of high level incentives which do not favour one solution over another.

Chapter 2: An outcomes led framework

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

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

In our view, questions 1 and 2 are linked. In principle, we agree that the framework should focus on the delivery of the desired outcomes. However, what the companies will actually deliver are the associated outputs and hence it is vital that these align with the desired outcomes. In general, we believe that the proposed categories of outputs are aligned with the outcomes, with the exception of safety. However, significant work is required to turn these broad output statements into measurable metrics.

We do not believe that safety is a suitable output measure for an economic regulatory framework. In our view, safe operation of the network is a pre-requisite to all other outputs. Safety regulation, of the network companies, is an issue for the Health and Safety Executive rather than Ofgem. Ofgem's responsibility is to ensure that the network companies are financed to meet their safety obligations. It is the company's responsibility to reject the price control if it believes that it cannot operate its network safely.

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

We believe that network companies should propose the outputs that they will deliver, informed by consultation with their stakeholders. We accept that Ofgem must ensure that the outputs align with its own statutory obligations. However, we are concerned that there may be an issue with competing stakeholder analysis. The stakeholder research by the distribution network companies will be specific to their region. An Ofgem survey will tend to be a more national view. Where there is a divergence between the two sets of analyses, it would be inappropriate for Ofgem to impose the national view, unless it could demonstrate that the alternative outputs were contrary to its statutory obligations.

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 ideas on how to improve engagement by network companies and Ofgem?

Given the changing role that network companies will have to perform in the future, it is essential that stakeholder views are considered in any future price control process. In addition, however, we support the view that the price control should remain a discussion between the companies and Ofgem.

The proposed range of survey methods (for example, deliberative forums, willingness to pay research) is also appropriate. However, with respect to willingness to pay research, it is vital that Ofgem utilises a consistent approach over time, so that large one-off shocks (such as the current ongoing financial crisis) do not distort the results.

The key proposal in this area is that companies should be more proactive in seeking stakeholder views and considering these in their long term planning process. We fully support this proposal. In our view, the DPCR5 stakeholder consultation process provides a useful starting point in developing this aspect of the process. From our perspective it provided a number of useful lessons, including these:

- **Short term issues tend to dominate stakeholder views** – With the exception of a few larger stakeholders the majority of views tend to focus on immediate issues. Consequently, both the requirements of future stakeholders and the need to minimise long term costs may not be fully represented. It is likely that Ofgem and the network companies will need to fulfil this role, drawing on their respective engagement with government.
- **The process is resource intensive** – The networks-related knowledge base of stakeholders is varied. If the process is to be successful then various engagement strategies will need to be developed.

The impact of the latter should not be underestimated. The engagement process will only be worthwhile if both the companies and Ofgem invest significant time and resource in it. However, in looking at Ofgem's engagement plan we are concerned that this might be an issue that is overlooked, given that Ofgem will be undertaking three price controls in relatively quick succession.

In its supporting paper, Ofgem states that it would consult stakeholders in advance of the first price control consultation paper. We are concerned that this approach will not give Ofgem a sufficient understanding of how stakeholder's views move over time. This is important, given the issue highlighted in the first bullet point above. The companies on the other hand will have been engaging with their stakeholders on a routine basis. This will provide them with more information on the constant stakeholder themes. We would suggest that the companies should present the output of their engagement regularly to Ofgem and its

key panels to facilitate a shared understanding of these concerns. This approach would also enable Ofgem to understand differing stakeholder priorities across the companies.

Ofgem's proposed range of stakeholders looks broadly correct. We note Ofgem's recognition of the issues that some consumer representatives face in engaging effectively. This concurs with our experience in DPCR5. We believe that there would be merit in Ofgem exploring how these bodies can be best helped to ensure that the views of the customers they represent can be put into the overall process.

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

We do not support the introduction of third-party rights of challenge to price control proposals.

It is not clear to us how such a right can be balanced with the requirement to protect the interests of future consumers, which Ofgem must consider equally alongside those of existing consumers. The process outlined in the paper envisages that third parties seeking to challenge a review outcome must demonstrate how it is detrimental to consumers, i.e. both existing and future consumers. However, existing customers or bodies representing them may not be the obvious representatives of the interests of this wider body of consumers. In our view, this distinction is important and raises a fundamental difficulty about the proposal to introduce third-party rights of challenge.

Third parties, along with most citizens, can already express their views on Ofgem's performance through the democratic process. Should these parties be able to make a case to government that Ofgem was not acting in accordance with its statutory duties, or indeed that those duties were no longer representative of the public interest, democratic pressure can be applied to amend the legal framework in which Ofgem operates, or to change the Secretary of State's social and environmental guidance, or to persuade government to exercise its existing legal right of veto over price control licence modifications.

The principal risk with the proposal to provide third-party rights of challenge is that every price control review would automatically be challenged, so that the Competition Commission, rather than Ofgem, would effectively set all network price controls. This would have the effect of destroying the network companies' existing rights of appeal to another body. Such an outcome would also inevitably change Ofgem's behaviour, since it would not need to engage with difficult issues which it knew would have to be addressed at the appeal stage by the Competition Commission anyway.

There is also a question of legitimacy. In principle, if third-party rights are to be developed they should apply equally to all, including individual consumers. However, this is unlikely to be practicable, which raises questions about the basis on which some groups should be included and others excluded.

The most worrying point about Ofgem's proposal, however, is the idea that the existing statutory framework of the Electricity Act is capable of providing a basis for the operation of a

third-party appeals regime. That framework was not designed for such a purpose and any attempt to make systematic use of it in the manner now proposed would be challengeable in judicial review.

If (despite our own concerns) there is a real consensus among the industry and its stakeholders that such a regime would be valuable in strengthening Ofgem's accountability to consumers, the obvious model on which to build, is the appeals framework already in existence under the Energy Act 2004 in relation to Ofgem's industry code modification decisions. That framework is merits-based: it also provides for the Competition Commission rather than Ofgem to decide whether a party (including, for example, a consumer body) has sufficient standing to appeal, and the whole appeal process must be conducted and completed within very tight statutory time limits.

There would clearly be scope, under future legislation, to adapt and evolve the Energy Act procedures into a third-party appeals regime in respect of Ofgem's price control proposals, should that be the decided public policy of a future government. Meanwhile, however, it would not be appropriate to misuse the reference procedures under the Electricity Act in the improvised and somewhat opportunistic manner now proposed by Ofgem as a quasi-appeals mechanism for third parties.

Chapter 4: Incentivising efficient long term delivery

EDF Energy is supportive of many of the initiatives in Section 4, as summarised in proposition 5 on page 24 of the main consultation document.

We strongly endorse a price control framework which is more tailored to the specific needs of each network company and the consumers and stakeholders that it serves. One could argue that Ofgem took a welcome first step towards this in DPCR5, for example by recognising the unique nature of certain very large projects and hence adopting the High Value Project approach, as an alternative means to assess the efficiency of plans and the subsequent delivery of those schemes.

It would be a major step forward for the price control to take account of the inherent differences between the different network companies. Such differences include:

- The nature of the networks and the load pressures they operate under (hence one might expect the network-related outputs to be justifiably different).
- Very different customer priorities and expectations, which need to be reflected in the respective business plans.
- The differing scale of requirements for capital investment.
- The differing scale of connections activity.

It is reasonable to conclude that all of these factors point towards the need for quite different price control settlements which are appropriate to each specific network company and its

users. It is, therefore, debatable whether the comparative analysis tools employed by Ofgem at DPCR5 are capable of delivering such an outcome.

Of course, this does not remove the need for a degree of uniformity in certain aspects of the price control regime, for example, in the form of guaranteed standards. However, if Ofgem wishes to see the network companies in the vanguard of moves to a more sustainable energy sector, and perhaps to expand into new areas of activity, then it must give the companies a little more breathing space, so that they can respond more effectively and innovatively to their consumers' and stakeholders' needs.

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?

As the Reckon paper notes, there are positives and negatives to extending all or some elements of the price control. At a high level, extending the price control with interim checkpoints would appear to the best solution. However, given the drive for a more sustainable energy sector, and the resulting level of uncertainty that companies face, we believe that it is highly likely that either Ofgem or the companies themselves would want the checkpoint to become a full review, hence defeating the purpose of setting a longer control.

We believe that, in the short term, maintaining the five year review window is appropriate. However, we believe that work needs to be undertaken to develop longer term targets. We envisage a situation where companies, in consultation with their stakeholders, would develop a strategic development statement for their network setting out the long-term objectives. Each price control would then be a building block towards achieving these objectives. In addition, setting each control within a long term framework would provide a company with the context to demonstrate why its strategic statement was cost effective in the long term.

Furthermore, the proposal elsewhere in this consultation for annual 'richer' business plans should in itself serve to reduce the administrative burden and the detailed scrutiny required at the formal price control. Equally, such plans should enable the industry to be more adaptable to stakeholders' needs and broader changes in the energy sector. These are all potential benefits that the Reckon paper identifies as worthy of pursuit.

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

We fully support giving greater discretion to network companies in formulating their price control business plans. However, Ofgem's inclination is to scrutinise a network company's business plan to a minute level of detail. In fact, as discussed above, the lesson of DPCR5, and of the revised regulatory reporting ("RIGs") that has emerged as a result, is of a desire to gather ever more granular detail about every aspect of a company's operations

Furthermore, the huge volume of data collected through the formal price control business plans did not prove adequate for Ofgem, resulting in hundreds of supplementary questions to the network companies. We have to ask whether Ofgem would really be satisfied with each network company producing its own business plan to its own format – or will this simply prompt an even greater level of questions as Ofgem attempts to make the business plans readily comparable.

In summary, there will need to be a significant change of the mindset within Ofgem if price control reviews are to rely on richer, innovative business plans produced by the network companies.

Assuming that Ofgem's mindset does so change, we believe that the plans should detail:

- The key business drivers identified.
- The stakeholder engagement process and the outcomes (and associated outputs) derived from the process.
- The scenarios considered and the rationale for picking the most likely scenario.
- The forecasting processes employed.
- Analysis supporting the chosen long term expenditure profile.
- As time progresses, an assessment of actual delivery against the plan and how accurate the original forecast was.

We would point out that the level of granularity, particularly in relation to the costs, will lessen due to the greater uncertainty in the longer term.

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

EDF Energy was very supportive of Ofgem's decision to equalise incentives between capex and opex as part of DPCR5. However, we are also very much aware of the implications that this has for any cost review at the next price control.

The opex cost review at DPCR5 proved to be an exceedingly complex and time-consuming process for all participants, including Ofgem. Likewise, a huge amount of effort was expended by Ofgem and the industry in the validation and justification of capex forecast costs. While we agree that Ofgem must now consider undertaking comparative analysis on a total cost basis, we know from our own experience that such analysis is complex and difficult. We believe that Ofgem needs to start work now to understand how such analysis should be undertaken, including the development of the appropriate drivers.

Notwithstanding the point above, there is a fundamental question as to whether Ofgem's historic statistical approach to benchmarking will be viable going forward. Generally, Ofgem analyses historic performance to assess the efficiency of future plans. In a world where companies may be delivering quite different outputs, such an approach is likely to result in

misleading conclusions, unless the analysis is further complicated by including the outputs in the statistical analysis.

In our view, it is no longer practical to suggest that Ofgem can test every cell in every spreadsheet of the business plan. It is inevitable that alternative methods will need to be adopted in future price controls, combined with a more varied toolkit of benchmarking and forecast validation techniques.

Ofgem rightly proposes that network companies might wish to undertake more benchmarking of their own activities, subject to such exercises being suitably independent. For example, drawing on the DPCR5 experience, we found the expert review of property management, undertaken by Drivers Jonas, to be a very beneficial exercise with genuine added value for EDF Energy. We believe that there would be benefit, both to Ofgem and the companies, in extending this approach to other corporate and back-office functions, such as call centres, stores, procurement, HR, and finance.

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

The fundamental criteria underpinning Ofgem's approach (i.e. that network companies are rewarded both for producing high quality business plans and for delivering against the outputs desired by stakeholders) are the correct criteria for assessing company performance. Ofgem's new proposal is that differential incentives and rewards will apply depending on a company's assessment against those criteria.

Our primary concern is that the document makes reference to perception being a key input to this process. This is wholly inappropriate. Either such decisions must be evidence-based or, in situations where judgement is to be applied, the basis for arriving at the judgement must be clearly set out.

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?

One of the successes of the DPCR5 programme was the inclusion of customer views at a number of stages in the process. The willingness to pay survey and the individual DNO stakeholder consultations all served to add clarity over the concerns and priorities of various customer and stakeholder groups.

EDF Energy firmly believes that greater customer and stakeholder involvement in the price control process would be a positive step, whether it is in helping Ofgem to shape the broad areas of focus in a price control review or prioritising the allocation of resources to particular initiatives. Likewise, network company business plans will be strengthened both through input to and challenge from the many and various stakeholder groups impacted by our investment decisions.

However, the process will only be of value to stakeholders if they can see a tangible benefit and specifically that network companies have the freedom to be genuinely responsive to their needs. As we have stated earlier, we have a concern (see Chapter 3, question 1) over the robustness of Ofgem's proposals for stakeholder engagement, and unless the identified issues are addressed we believe that the process may be devalued.

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?

There appears to be something of a contradiction in Ofgem's proposals, as the direction of travel in recent years has been towards a much greater standardisation of charging methodologies across the distribution industry. However, Ofgem is right to identify charging methodologies as an important consideration, particularly during the transition to a sustainable and more secure energy sector.

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?

Please see our response to question 4.

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

The concept of engaging a third party to undertake delivery of a project, particularly a capital project, is already intrinsic to the operation of many network companies. From an EDF Energy perspective, the DPCR4 period saw a very substantial increase in capital expenditure, which could not have been achieved without the involvement of a range of partners, operating through a variety of contractual arrangements.

The proposition that specific schemes should be carved out of a network company's business plan and delivered by an alternative party, possibly on a design/build/operate (DBO) basis, should not be taken forward. As we have explained above, we see little merit in Ofgem pre-selecting particular delivery approaches rather than relying on high-level incentives to determine the most efficient outcomes.

It is also worth reflecting on a number of the challenges which would accompany such an approach, and which the supplementary paper rightly identifies:

Firstly, there is the extent to which the scheme can be readily 'isolated' from the rest of the network so as to create a tender that is clearly scoped and where the interfaces with the surrounding network are well understood.

Secondly, there will be the need for detailed contractual arrangements between the third party and the network company so as to ensure the smooth operation of the whole system. For example, there would need to be clear agreements on such matters as outage planning and fault resolution.

The practical challenges, while not insurmountable, need to be taken very seriously and we would suggest that there will be a relatively limited number of schemes which might be appropriate for such treatment.

The supplementary paper also raises the prospect of specific schemes being tendered, potentially by Ofgem rather than the network company. The example of offshore transmission is cited, but what is essentially a greenfield site is very different from a project which is intimately connected to a large and complex existing network infrastructure. We would question whether Ofgem has the technical capability to conduct such tenders and, indeed, whether it is its proper role to do so.

We would be concerned that such an approach may actually increase costs for customers as it may adversely restrict the types of contracting strategy that can be employed, while creating additional on-going operating costs through the requirement to manage and co-ordinate the boundaries between the network company's operations and infrastructure and those of the tendered operator.

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?

Our key comments our Ofgem's proposals are:

- We agree that innovation should in principle extend to all types of relevant innovation.
- Network operators have demonstrated a positive engagement with innovation incentives such as IFI: indeed, there is no evidence that innovation in other countries is any further advanced other than where deregulation has not created barriers to vertically integrated innovations.
- The benefits of permitting third-party access are unsubstantiated. The proposals are predicated on the assertion that network operators are risk averse whereas the evidence is strongly to the contrary: indeed, network operators have become expert at risk management, not risk minimisation. The proposals also do not appear to have considered the implications, in terms of safety and statutory compliance, of allowing network access to third parties. As a minimum, any such third party will need to be carefully vetted for competence by the affected network operator.
- The benefits of innovation in electricity networks have so far been too narrowly considered: demand management has a much wider and important role to play in delivering the Renewable Energy Strategy (RES) and Low Carbon Transition Plan (LCTP) than simply offsetting network capacity investment.
- Given that the Low Carbon Networks Fund is still under development (and yet has already received a very positive response from DNOs), it is premature to suggest that this imaginative scheme will not be successful in delivering the required innovation.

The key arguments that have been deployed are that network companies have failed to innovate and that third parties should be allowed to undertake trials on a network company's system without the participation of that company. With respect to the DNOs, it cannot be emphasised too strongly that the ongoing integrity of the electricity distribution system is dependent on expert management. Apart from licence conditions, there are important Distribution Code and statutory obligations (for example, the ESQC and CDM regulations) concerning the safety of the industry's workers, the safety of the general public, and the quality and continuity of electricity supplies. The provisions of the highways and traffic management legislation may also be relevant.

The electricity transmission and distribution systems are not 'living laboratories' to be available for hire by any authorised party wishing to conduct experiments with new technology. Demonstration of compliance with certain skills and the possession of a measure of experience are not in themselves sufficient to ensure that the important matters identified above would be sufficiently addressed by a third party.

In addition, the DNOs are subject to a range of incentives relating to the performance of their networks. Allowing third parties to trial new technology on the network may result in DNOs failing to achieve other regulatory outputs and hence the potential to incur financial penalties. This is inappropriate. In fact, if a third party is finding it difficult to find a network company to partner with, there are probably good network/operational reasons for this.

The statement in the working paper that DNOs have historically been slow to innovate has been taken out of context. The context of that observation is that RPI–X regulation has, prior to the introduction of IFI, provided a strong incentive not to incur discretionary costs associated with R&D. In addition, part of Ofgem's reason for equalising incentives was to make tools such as demand side management more viable for DNOs. Our view is that there is no evidence that network companies do not want or are unable to innovate. In fact, we would argue that once the regulatory framework provided the correct incentives, the companies have responded proactively.

We are also concerned that the document appears to believe that the new Low Carbon Networks Fund will fail to deliver before it has started. We fully supported the introduction of this mechanism and commended Ofgem for recognising the need for a more radical approach. The scheme already incorporates important key features such as collaborative working and competition. We believe that the LCNF scheme could be extended to cover the future desired objectives of:

- Being applicable across each of the networks, rather than just to one, and
- Being open to all forms of innovation, potentially covering a wider set of projects.

In summary, it seems premature to be developing a new innovation incentive without at least ascertaining if the current one will deliver or not. If it does not, then we should attempt to learn the lessons from that before embarking on a substantially new path.

EDF ENERGY

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

Our response to Ofgem's financeability proposals are set out in a separate appendix to this response.

Section 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?

In the majority of areas, a new framework should be able to deliver the required outcomes within the existing structure. Our main point of concern is the ability of network companies to progress non-network solutions in the absence of an interested third party, or if the third party cost is prohibitive. For example, investment by distribution companies in either generation or energy storage is problematic under the current structure.

It would seem sensible to ensure that the structure is developed so that, in the absence of a third party prepared to partner with the distribution company at a reasonable cost, those types of solution are not precluded.

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?

Yes, where this is demonstrated to be the most effective long term solution. In our view, further consideration should be given as to who can propose changes to the various industry codes. For example, distribution companies cannot propose changes to the Balancing and Settlement Code, and this impacts on their ability to reduce reported system losses.

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

We believe that network companies should strive to meet the needs of all their respective users, including the development of appropriate charging methodologies, in a non-discriminatory manner. If this was not achieved, we would expect regulatory intervention. We see no reason at present to single out energy service companies for special attention.

Appendix 2: EDF Energy's Response to Ofgem's Proposals on Financeability

1. 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?

It is important for Ofgem to develop a clear set of financeability principles: after all, this is a fundamental aspect of any price control review. In recent years, economic regulators appear to have been changing their views on financeability, and in particular the circumstances in which financeability adjustments (typically revenue uplifts and/or accelerated regulatory depreciation) are deployed. This has created a degree of uncertainty as to the circumstances that will lead to such adjustments. One of the most important benefits of a predictable regulatory regime is that is reduces the financing costs for companies, and hence reduces prices for consumers.

In this response, we state what we believe are the key financeability principles that Ofgem should employ. In arriving at these principles, we reject Ofgem's simplistic contention (see paragraph 1.8 of its paper) that 'ultimately capital markets should be indifferent to the speed of money and/or the rate at which the RAV is repaid as long as the cost of capital is appropriate'.

In the debt markets, a 'term premium' can be observed in relation to both index-linked and nominal bonds. Given that equity tends to be more exposed to risk than debt, we would expect equity to exhibit an even stronger term premium. More particularly, in order to maintain investment grade credit ratings (a requirement that Ofgem confirms in its recent paper on the financial ring-fence) in a period of cash shortage, equity would need to inject cash.

Where the cash shortfall is not caused by RAV growth above inflation, the return on equity would fall (because the cash injected would not attract additional returns since the RAV had not grown proportionately). For equity to be 'speed of money' neutral (as Ofgem asserts) would therefore require certainty that the missing returns will be paid at some future time, implying a commitment for Ofgem to set a future price control with a higher than normal cost of equity.

The regulatory risk of this not happening must be considered to be very high, particularly given:

- Ofgem's RORE policy which calibrates returns for each five year period, and
- The Authority's reluctance to bind its own future decisions

As a result, equity would charge a premium for carrying such risk (assuming that it was prepared to invest at all).

Our key principles are set out below. They are predicated on Ofgem setting a realistic cost of capital. Al three principles are important and must be met at any point in time.

1. Licensees must be required to **maintain investment grade credit ratings** as per the current licence obligations. We note below that even though Ofgem may cast doubt on the work of the credit rating agencies, what matters is the reliance placed on them by providers of finance. We also note that in its recent consultation document on the financial ring-fence licence conditions, Ofgem is proposing to retain the requirement on licensees to maintain an investment grade credit rating. Without maintaining an investment grade credit rating, NWOs would not be able to access finance at a reasonable cost.
2. Injections of **additional equity should only be assumed where needed to finance real RAV growth**. Ofgem should not assume an injection of equity, which would dilute the value of existing equity, for the following reasons:
    - Reliance on such an assumption would effectively allow the Authority to circumvent its duty to have regard to the ability of licensees to finance their activities (and hence run counter to Parliament's intentions).
    - The equity injection required to finance a steady state RAV (at a steady state level of gearing) would not earn the cost of equity (unless in some future period Ofgem allowed for higher returns to ensure speed of money/NPV neutrality), which would result in a large increase in regulatory risk.
    - Any rights issue would be seen by the markets as a forced injection needed to avoid insolvency – and so, even if it were achievable, would attract a premium to the cost of equity.
3. The price control mechanism should provide a **stable and predictable flow of dividends to equity** holders for an efficient company (unstable dividends and/or long periods without dividends either increase the cost of equity or reduce its supply).

On the second bullet point above, we draw attention to the evidence cited by Bristol Water plc in its recent full statement of case to the Competition Commission:

> *The high levels of return required in such situations is shown in practice by the 20% rate paid on the preference shares issued by Anglian Water's parent in 2009 in order to reduce gearing levels following the adverse impact of negative inflation on the RCV-to-debt ratios compared to those set out in debt covenants. (paragraph 1513)*

2. How should we strike an appropriate balance between the interests of current and future consumers in determining the appropriate assumed asset life behind the depreciation profile?

3. How should the views of future consumers be taken into account?/ How should these views be embedded in our approach to capitalisation and depreciation?

Questions 2 and 3 are similar and we provide a combined response below.

Ideally, the cost of assets should be matched against the periods in which they are used. However, in practice this is not possible because the initial RAVs set shortly after the privatisation of the DNOs in 1990 were based on the share price at the end of the first day's trading, and not on the underlying costs of the distribution assets in use at the time.

The problem persists with the current estimated value of these assets. The MEAV (or modern equivalent asset value) is many times the size of the equivalent RAVs (see the table below), meaning that past consumers have already fully paid for the assets that the current generation of customers are using. Against this background, accelerated regulatory depreciation could be seen as a positive development, since it brings charges to current customers closer to the costs of the assets being used and implied by the MEAV (although we note below that there is little purpose in sending economic signals through the allocation of sunk costs).

DNO (All values £m at 07/08 prices)	MEAV	RAV Forecast value at close of 2009/10	RAV as %age of MEAV
CN West	7668	1380	18%
CN East	8769	1338	15%
ENW	7879	1212	15%
CE NEDL	5252	827	16%
CE YEDL	7374	1057	14%
WPD S Wales	3931	669	17%
WPD S West	5312	914	17%
EDFE LPN	5859	1203	21%
EDFE SPN	6709	1008	15%
EDFE EPN	10667	1659	16%
SP Distribution	6881	1283	19%
SP Manweb	5907	1082	18%
SSE Hydro	3647	838	23%
SSE Southern	10120	1654	16%
Total DNOs	**95974.8**	**16123**	**17%**

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4. If balancing the interests of current and future consumers implies longer asset lives, what does this mean for financeability assessment (particularly if cash flow ratios in the short term are below those assumed by the rating agencies to be consistent with investment grade credit rating)?

We do not agree that balancing the interests of current and future consumers means a lengthening of asset lives. As we point out in our answers to questions 2 and 3 above, shorter depreciation lives actually help to redress the imbalance caused by RAVs being set well below MEAV levels (i.e. there is already a significant distortion between existing and past consumers).

5. If depreciation is accelerated, what happens when the RAV is largely depreciated but the assets remain useful?

In theory, such a situation would be unsustainable under Ofgem's current approach because the NWO concerned would be making zero returns (as the RAV would be zero) but would still be incurring operating risk (it would still need to service its customers). However, in practice companies are, and will need, to continually invest in different classes of assets, as they become in need of replacement, and so the problem is unlikely to arise in practice.

6. 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?

Price signals are useful where they reflect forward-looking investment decisions. However, a NWO's revenue requirements are primarily in respect of sunk costs (the RAV), suggesting strongly that Ofgem should not place much weight on sending economic signals through the level of aggregate revenues.

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

We do not agree that the cost of capital assumption for DPCR5 allows for an averagely efficient company to earn an appropriate return. We regard such returns as at least 30 basis points above Ofgem's estimate, meaning that incentive out-performance is necessary to finance an averagely efficient company. We do not believe that this was signalled transparently to the companies prior to Ofgem's Final Proposals (a significantly negative aspect of the DPCR5 process), nor do we believe that the policy was delivered in a transparent manner.

Ofgem's opaque approach to its DPCR5 RoRE/WACC assessments has damaged our confidence in Ofgem and should not be repeated. We could only support Ofgem's DPCR5 use of RoRE analysis going forward if the intended trade-offs between RoRE outperformance and the WACC are clearly revealed at a sufficiently early stage in the price control process.

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8. Is there merit in providing differentiated allowed rates of return for companies within a given sector?

We believe that there is merit in providing differentiated rates of return between companies where it can be shown that the risks are different, although we recognise the practical difficulties of doing this.

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