

Energy Networks Association – ENA

**ENA Response to Ofgem’s ‘Emerging Thinking’ and ‘Third Party
Right to Challenge’ Consultations**

9th April 2010

1 Introduction

Ofgem has recently published three consultation papers as part of its RPI – X@20 project. ENA has responded separately to ‘Embedding Financeability in a New Regulatory Framework’. This note represents ENA’s response to Ofgem’s ‘Emerging Thinking’ and to its consultation on the right of third parties to challenge Ofgem’s price control decisions.¹

We have structured our response to the issues raised in Emerging Thinking under four headings:

- the mechanics of price controls and price reviews;
- the role of consumers and other third parties in the regulatory process;
- the role of competition in delivering network outputs;
- access to existing energy networks.

Section 2 is an Executive Summary. Sections 3–6 describe in more detail ENA’s views on each of the four areas above, and section 7 contains our response to the consultation on the right of third parties to challenge Ofgem’s price control decisions.

2 Executive Summary

ENA is putting forward the following views on Ofgem’s Emerging Thinking consultation and on its consultation on third-party challenges to Ofgem’s price control decisions.

- We agree with Ofgem’s overarching preference for an enhanced ex ante approach to future energy network price reviews.
- Within that overall approach, we agree with the focus on outputs/outcomes and on the desirability of a specific innovation stimulus.
- We agree that the equalisation of incentive rates between CAPEX and OPEX will not, by itself, eliminate distortions to the incentives to choose OPEX or CAPEX solutions. Furthermore, we think that Ofgem should not underestimate the problems entailed with total cost benchmarking. In addition, Ofgem’s recent decision to equalise incentives was an integral part of the whole DPCR5 package and accepted as such. Therefore, any proposal to apply the same policy to gas distribution and/or the transmission price controls should be considered on the same basis, that is, in the context of the whole price control package.
- We do not think that either of the two forms of partial longer-term price controls which have been proposed by Ofgem’s consultants would be likely to improve incentives for efficient long-term delivery, but think that there is scope for exploring longer-term regulatory arrangements for specific projects with longer-term payoffs to NWOs.

¹ Ofgem (2010), ‘Emerging Thinking’, January 20th. Ofgem (2010), ‘Emerging Thinking – Third Party Right to Challenge Our Final Price Control Decisions’, January 29th.

- We agree with Ofgem’s rejection of constructive engagement, but we also agree with Ofgem about the desirability of enhancing third-party engagement in the regulatory process and with building on the DPCR5 process to achieve this aim.
- We do not think that third parties having the right to challenge Ofgem’s price control decisions would facilitate Ofgem’s balancing of the interests of existing and future consumers, especially in the context of government’s increasingly specific definition of the latter. However, if third-party challenge is to be allowed, then it should only be allowed to designated bodies whose interests are clearly aligned with those of consumers—and such a designated body or bodies should bear an appropriate proportion of the costs involved with an appeal to the Competition Commission (CC).
- We note, and agree with, the qualifications which Ofgem attaches to its proposal to have the option of competitive tendering for some aspects of delivery.
- We think that Ofgem’s proposals in respect of access to existing energy networks lack clarity, and may be somewhat inconsistent with the approach that Ofgem has hitherto been following on charging for network access in electricity distribution.

3 Mechanics of price controls and price reviews

3.1 What Ofgem is proposing

Ofgem has rejected a move to ex post regulation and has also rejected the negotiation of price controls between energy network companies and network users/consumers (i.e., ‘constructive engagement’). Instead, Ofgem has proposed enhancing the existing ex ante framework.

The main enhancements being considered include, in particular:

- more elaborate business plans;
- more explicit identification of outputs that energy networks are required to deliver, and more financial incentivisation of the delivery of those outputs;
- equalisation of incentives between CAPEX and OPEX solutions;
- a specific innovation stimulus which would replace the Innovation Funding Initiative (IFI) and would build on the Low Carbon Networks (LCN) Fund which has come out of DPCR5;
- the potential for at least partial longer-term price controls.

The two main options put forward for partial longer-term price controls are as follows:

- Set a longer-term price control, but with a review of required outputs at some intermediate point, and an adjustment of revenue only insofar as required outputs are changed.
- Set a longer-term control but, at an intermediate point, make a *partial* (eg, 50%) revenue adjustment for actual costs turning out differently from what was assumed when the control was set.

One consequence of sticking with ex ante regulation, but enhancing it to incentivise the delivery of a more comprehensive set out of outputs, is that price controls and the process of setting them would involve an increase in complexity and regulatory burden. This issue is partly addressed by implying that scrutiny of business plans would vary with the ‘quality of the business plan and the company’s reputation for efficient delivery’ (i.e., high-performing

companies could reduce the regulatory burden), and partly addressed in the supporting paper on the simplicity of the regulatory framework.² In effect, Ofgem's proposals on simplification—one of the original objectives of the RPI – X@20 project—amount to helping everyone (Ofgem, energy networks, third parties) live with the additional complexity through:

- enhancing the effectiveness and accessibility of information;
- aggregating and rationalising incentives (which, in the natural order of things, tend to proliferate in a rather ad hoc way to deal with particular issues);
- 'streamlining' of processes and 'targeting' of regulatory efforts.

3.2 ENA's response

For the reasons set out in our November submission to RPI – X@20, we agree with Ofgem's overarching decision to go for an enhanced ex ante approach to future price controls. Within that overall approach, we also agree with:

- the proposed focus on outputs and outcomes;
- the need for a specific stimulus for innovation, not least to address issues associated with externalities and the inconsistency between the duration of price controls and the time over which innovation might pay back.

We comment below on some of the other specific proposals on the mechanics of price controls which Ofgem is making with respect to:

- equalisation of incentives between CAPEX and OPEX;
- partial longer-term price controls;
- simplification of the regulatory process.

Equalisation of incentives between CAPEX and OPEX

We note that Ofgem recognises that equalisation of incentive rates between CAPEX and OPEX (as, for example, with the treatment of network expenditure in DPCR5) will not, by itself, eliminate distortions to the incentives to choose OPEX or CAPEX solutions. In particular, Ofgem recognises (para 5.40 of the supporting paper on incentivising efficient long-term delivery of desired outcomes)³ that distortions can arise from using different methods for assessing OPEX and CAPEX requirements. Ofgem will also, however, be aware of the problems of benchmarking total (operating and capital) expenditure, especially in the context of different measures of capital stock.

In addition, Ofgem's recent decision to equalise incentives was an integral part of the whole DPCR5 package and was accepted as such. Any proposal to apply the same policy to gas distribution and/or transmission price controls should therefore also be considered in the context of the whole price control packages.

Partial longer-term price controls

Ofgem's support for partial longer-term price controls stems from its desire to incentivise longer-term delivery, alongside its recognition of the need for price controls to be adaptable in the face of, in particular, (a) changes in the outputs/outcomes required of networks, or (b) changes in the economic environment in which networks operate. While we understand the theoretical attractions of partial longer-term controls in balancing these competing concerns, we are not convinced that either of the two options put forward by Reckon (and summarised in section 3.1 above) are the solution.

² Ofgem (2010), 'Emerging Thinking – Simplicity of the Framework: Issues to Consider', January 20th.

³ Ofgem (2010), 'Incentivising Efficient Long-term Delivery of Desired Outcomes', January 20th.

This is because either option would increase exposure in a rather blanket way to the sort of changes in economic environment (including input costs) which have seen substantial swings over the last few years and which are largely outside the control of companies. There is the risk that Ofgem would not compensate companies for this increased exposure with an appropriate increase in the assumed cost of financing, not least because one of the problems recognised by Ofgem with longer-term price controls is the risk of ‘excessive returns at the expense of customers’.⁴ In other words, the sort of conflicting pressures which have led UK regulators to overwhelmingly choose five-year price control periods (notably, the increased risk of excessive or inadequate returns) would not be mitigated by either of the two forms of partial longer-term price controls proposed by Reckon.

Instead, we think that, if Ofgem is looking to experiment with longer-term price controls, then it should look to be applying them in a more focused way, perhaps to particular projects where the likelihood is that benefits will accrue to networks over periods significantly longer than five years, albeit that the new innovation stimulus will be designed to cope with situations where benefits are likely to accrue to other parties and/or over longer periods.

Simplification of the regulatory process

On this issue, we agree with Ofgem’s (implicit and explicit) position that some increased complexity is a necessary price to be paid for otherwise desirable enhancements to the existing ex ante framework, and that proposals in this area should be aimed at helping all parties to live with that complexity.

4 The role of consumers and other third parties in the regulatory process

4.1 What Ofgem is proposing

The core Ofgem propositions on the role of consumers in the regulatory process are as follows.

- Constructive engagement is not desirable.⁵
- Enhanced engagement with consumers is desirable. Network companies will be rewarded for effective engagement with consumers⁶ and Ofgem will pursue its own engagement with consumers through a variety of means, several of which are already in place.⁷
- The right of third parties to challenge Ofgem’s price control decisions is for further consideration (and is covered by a separate consultation).

4.2 ENA’s response

We agree with Ofgem about the undesirability of constructive engagement, not least because, as we described more fully in our November submission on RPI – X@20, we can see no natural alignment between the interests of the obvious constructive engagement counterparties and consumers.

⁴ Ofgem (2010), ‘Emerging Thinking’, January 20th, para 6.9.

⁵ Ofgem (2010), ‘Emerging Thinking’, January 20th, para 3.9.

⁶ Ibid., para 3.17.

⁷ Ibid., para 3.32.

We agree that enhanced engagement with existing consumers is desirable, and see the process followed in DPCR5 as being a reasonable basis on which to build in future reviews, including through the ‘price control review forum’ which Ofgem has proposed.

However, one issue that is not as explicit in Emerging Thinking as it is in, for example, the supporting paper on alternative ex ante and ex post regulatory frameworks,⁸ is how engagement with consumers fits in with Ofgem’s evolving statutory obligations in respect of consumers—for example, not only did the Energy Act 2008 elevate the duty to *future* consumers, but the new Energy Act also makes it explicit that the interests of (existing *and* future) consumers include their interests in security of supply and reduced emissions of greenhouse gases.

Thus, enhanced consumer engagement may help inform both Ofgem and network companies as to what existing consumers want—and Ofgem is clear in seeing the role of enhanced engagement as informing, rather than supplanting, its own role in making regulatory decisions⁹—but there is also a sense that what consumers want may soon be specified, at least partially, in a new act.

This has potentially significant implications for the right of third parties to challenge Ofgem’s price control decisions. Thus, Ofgem is proposing that ‘parties seeking to launch a challenge would need to demonstrate that they were seeking to address an aspect of the proposed price control that could be detrimental to consumers’¹⁰—but existing consumers, or bodies whose interests are aligned with existing consumers, may not be the obvious representatives of consumer interests, which are, and may to a greater extent in the future, be described in Ofgem’s statutory obligations.

Further thoughts on the right of third parties to challenge Ofgem’s price control decisions are in section 7.

5 The role of competition in delivering network outputs

5.1 What Ofgem is proposing

Ofgem has previously rejected full network-on-network competition.¹¹ In addition, Ofgem makes it explicit (in its supporting paper on the role of competition in delivery) that: ‘We expect the majority of outputs to continue to be delivered by the network companies’.¹²

The core of what Ofgem is now proposing in this area is that it wants the *option* to require competitive tendering as a threat to encourage efficient behaviour by incumbent networks.¹³ Ofgem has also, in its Emerging Thinking, elaborated on the criteria which would need to be met to require exercise of the option. These include:

- the project to be sufficiently big to justify the costs associated with competitive tendering;
- the project to be sufficiently separable from other network activities;
- competitive tendering not to get in the way of timely delivery;

⁸ Ofgem (2010), ‘Alternative Ex Ante and Ex Post Regulatory Frameworks’, January 20th.

⁹ Thus, in its supporting paper on alternative ex ante and ex post regulatory framework, Ofgem says ‘In any new regulatory framework, we think that Ofgem should continue to make regulatory decisions, taking account of information from an enhanced engagement process’ (para 3.17) and ‘... it is not clear whether existing network users would give sufficient priority to encouraging innovation by network companies that can contribute to a sustainable energy sector’ (para 3.18).

¹⁰ Ofgem (2010), ‘Emerging Thinking – Third Party Right to Challenge Our Final Price Control Decisions’, January 29th, para 5.5.

¹¹ Ofgem (2009), ‘Enhancing Competitive Pressures on Regulated Networks: Ofgem’s Current Thinking’, October 6th.

¹² Ofgem (2010), ‘Supporting Paper on a Greater Role for Competition in Delivery’, January 20th, para 2.3.

¹³ Ofgem (2010), ‘Emerging Thinking’, January 20th, para 4.47.

- the existence of companies willing and able to deliver the project in question and likely to add value in doing so;
- there to be a concern about the costs proposed by the incumbent network.¹⁴

5.2 ENA's response

Against the background of the urgency with which the government regards meeting decarbonisation targets, Ofgem's criteria for requiring particular projects to be competitively tendered would seem to limit competitive tendering to large and discrete *transmission* projects for which competitive tendering arrangements (both the arrangements for conducting the tender and the contractual/regulatory arrangements which are being tendered for) could be put in place with some speed.

In response to this, we would make the following points.

- As noted in our November submission to Ofgem on RPI – X@20, the issue of timeliness is not a trivial one in relation to competitive tendering for large infrastructural projects. As we have previously pointed out, the project to put in place competitive tendering for offshore transmission has already taken over five years and has still not resolved how the regime will work for projects which are yet to be built.
- The difficulty of designing tendering arrangements will typically be multiplied if the aim of the arrangements is to generate different options for delivering the required outputs, rather than simply to generate competition to build and/or operate a reasonable, detailed specification put forward by a third party. However, without a tender that generates different ways of doing the work, the rationale for competitive tendering is much diminished.
- Although Ofgem says that 'in many cases tenders would be run by the network companies themselves', it also says that, in some circumstances, Ofgem may run the tender.¹⁵ It is not obvious how competitive tendering where Ofgem is the counterparty (as with offshore transmission) fits with Ofgem's oft-mentioned information asymmetry between itself and network companies.

6 Access to existing energy networks

6.1 What Ofgem is proposing

Ofgem continues to be significantly concerned with the potential role of Energy Service Companies (ESCOs) and with the terms by which they can obtain access to existing energy networks. Ofgem's proposals in this area cover:

- the need for regulatory action 'if energy service companies are viable, but are not able to obtain reasonable access terms to distribution networks services';¹⁶
- encouragement to distribution network companies to 'provide standardised, efficient, effective, timely, transparent and non-discriminatory access terms';¹⁷

¹⁴ Ofgem (2009), 'Enhancing Competitive Pressures on Regulated Networks: Ofgem's Current Thinking', October 6th, para 2.13.

¹⁵ Ofgem (2010), 'Emerging Thinking', January 20th, para 4.49.

¹⁶ Ibid., para 5.11.

¹⁷ Ibid., para 5.14.

- the intention to ‘explore the potential to require network companies to lease, or even sell, assets if they fail to offer fair and timely access terms’,¹⁸ albeit that Ofgem ‘would not expect it to be commonplace for energy service companies to buy or lease assets’.¹⁹

6.2 ENA’s response

At least two possible problems arise from Ofgem’s proposals in this area.

- There is significant vagueness and subjectivity implied by some of the terms which Ofgem is using in this area. The need for ‘reasonable’ access terms for ‘viable’ energy service companies begs many more questions than it answers.
 - Who determines a company’s viability?
 - What is the basis of that determination, and how does it fit with ‘reasonable’ access terms?
 - Are reasonable access terms objectively defined (on the basis of cost-reflectivity, for example) or are they, for example, what is needed to make the company ‘viable’, thus implying some degree of logical circularity?
 - How far does pressure to facilitate delivery of a low carbon economy override other, and hitherto paramount, licence obligations for energy network companies?
- There are potential conflicts between what Ofgem would seem to be proposing and its more general ongoing policy on network access. ‘Standardised’ and ‘non-discriminatory’ terms may be seen as ‘unfair’ by the company wanting access. This may be a particular issue in relation to the distribution network use of system (DNUoS) charging methodologies which have been emerging from electricity distribution companies in discussion with Ofgem. These methodologies have arisen, at least in part, from suppliers wanting more consistency and certainty about charging on a national basis. If these methodologies give rise to ‘unfair’ swings in particular locations (in relation to local distribution costs), they will typically be balanced for a national supplier by the ‘roundabouts’. This insouciance might not be shared by a local energy services company, but it is not clear how tension between fairness, standardisation, cost-reflectivity, non-discrimination, etc would have to work itself out to prevent Ofgem requiring a network to sell or lease lines to the ESCO in question (subject to Ofgem acquiring the legal right to implement such a requirement).

In addition to the above, we would make the following two points:

- Compelling the sale or leasing of a part of the existing network to what could then be a local vertically integrated monopoly—with an interest in excluding others from access to its network—would require at least the same level of open access obligations on the purchaser/lessee as currently apply to incumbent network businesses.
- Ofgem’s ability to deploy some of the sanctions which it mentions in relation to network access—compelling the incumbent network to sell or lease parts of its network—would require statutory powers which it does not currently possess.

¹⁸ Ibid., para 5.15.

¹⁹ Ibid., para 5.16.

7 Third-party right to challenge Ofgem's price control decisions

7.1 What Ofgem is proposing

The issue of third-party challenges to Ofgem's price control decisions has probably received more published attention than any other of the topics in RPI -X@20. The current consultation contains:

- a long list of reasons in favour of allowing third-party challenges, including:
 - encouragement of stakeholder involvement in the regulatory process;
 - improved accountability, transparency and legitimacy for Ofgem's decisions;
 - increased incentives on network companies to engage with third parties;
 - alignment with trends in airports and telecoms regulation;
- a longer list of reasons against, including:
 - perceptions of increased regulatory risk and uncertainty;
 - increased cost of regulation and increased complexity of the regulatory process;
 - the risk of unwarranted challenges;
 - increased risk of delays to new price controls being implemented;
 - undermining of Ofgem's role and authority;
 - the potential to distort regulatory decision-making by giving undue attention to the interests of particular stakeholder groups;
- a 'straw man' of how an appeals process might work, including that:
 - any appeals process would be under existing legislation;
 - grounds for challenge would relate to a material detriment to consumers resulting from Ofgem's final proposals;
 - Ofgem would be the 'gatekeeper' of the process, determining which challenges would be allowed and would frame the reference to the Competition Commission (CC);
 - the CC would decide whether there was a public interest concern raised by the challenge and would recommend what price control modification would be required to address any such issue;
 - all parties would pay their own costs and, potentially, some of Ofgem's costs, and current arrangements for paying the CC's costs would apply.

7.2 ENA's response

In our previous submission, we suggested that a third-party right to challenge Ofgem's final price control proposals might:

- not help to balance the interests of existing and future consumers;
- hinder the achievement of government energy and climate change policy.

This was on the basis that:

- Ofgem's obligations have been progressively weighted to the interests of future consumers who would obviously not be directly represented by any challenging party, albeit that different third parties would each have their own views as to what would be in the interests of future consumers;

- government would seem, as in the 2010 Energy Act, to be increasingly taking a view on how the interests of future consumers are defined, particularly with respect to security of supply and decarbonisation of the energy sector.

With Ofgem's statutory obligations in respect of future consumers thus becoming increasingly specific, it is not clear how allowing third-party challenges would be helpful to Ofgem in meeting those obligations.

Having said this, if third parties are to be allowed to challenge Ofgem's decisions, we think that the process should at least meet the following criteria.

- The interests of parties who are able to challenge should be clearly aligned with those of consumers. In our view, this would rule out allowing challenge from suppliers for the reasons given in our earlier submission—that, because an individual supplier will typically not obtain a competitive advantage from the development of networks, suppliers collectively do not have the interest in that development that consumers might have. It is worth noting that current (Department for Transport) proposals for the reform of airport regulation envisage a designated passenger body, Passenger Focus, being able to appeal licence modification decisions—but do not envisage airlines or other parties having the same right. It has been pointed out that, among other things, airlines do not have an interest in airport investment which facilitates increased airline competition at the airport in question. We suggest that a similar logic might involve designating a body such as Consumer Focus in relation to energy network price controls.
- As proposed by Ofgem itself, parties should bear an appropriate proportion of the costs of a challenge—so that, in Ofgem's words, 'there is a real downside to lodging such a challenge'.²⁰ This should apply even if only one or more bodies were designated as being able to appeal against Ofgem's price control decisions.

As Ofgem's proposals currently stand, however, we could not endorse the idea that the existing statutory framework of the Electricity Act 1989 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, we think, be liable to be quashed in judicial review proceedings.

If 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 and on the basis of clear statutory rules of procedure.

There would clearly be scope, under future legislation, to adapt and evolve the Energy Act 2004 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, in our view, somewhat opportunistic manner now proposed by Ofgem as a quasi-appeals mechanism for third parties.

²⁰ Ofgem (2010), 'Third party right to challenge', para 5.11.*