

Third Party Right of Appeal

A submission by National Grid plc prepared
by PA Consulting Group

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Executive summary

This report has been produced by PA Consulting Group ('PA') for National Grid plc ('National Grid') and represents its response to the Office of the Gas and Electricity Markets' ('Ofgem's') Third Party Right of Appeal consultation. The report is intended to inform the right of appeal debate drawing on insights and analysis of approaches in other jurisdictions and sectors. In particular, this report examines whether a right of appeal is required and on the basis it is, what the most effective and efficient mechanism would look like from a first principles perspective.

Proposed third party right of appeal mechanism

Ofgem is consulting on a potential design of a third party right of appeal

Ofgem is undertaking a detailed review of how it regulates energy network companies, and in particular, whether the existing 'RPI-X' frameworks remain 'fit-for-purpose'. Ofgem has proposed under any new arrangements, there would be greater emphasis on energy network companies understanding the demands of existing consumers and anticipating what is needed for future consumers. Ofgem has emphasised that enhanced engagement with third parties by network companies and by Ofgem may improve transparency, quality and legitimacy of decision-making.

In the context of this debate, Ofgem has scoped out for consultation the potential introduction of a third party merits-based right to appeal Ofgem's final price control proposals. In particular, the regulator has identified key issues that need answering when considering the design of such a mechanism:

- Who can appeal the regulator's price control decisions?
- On what grounds can the appeal be made?
- What is the nature of the appeal?
- What aspects of the price control can be appealed?
- Who decides whether the appeal is warranted?
- What would the timescales be for any appeal?
- When would the price control licence condition be implemented?
- What would the outcome be?
- Who would pay the costs of an appeal?

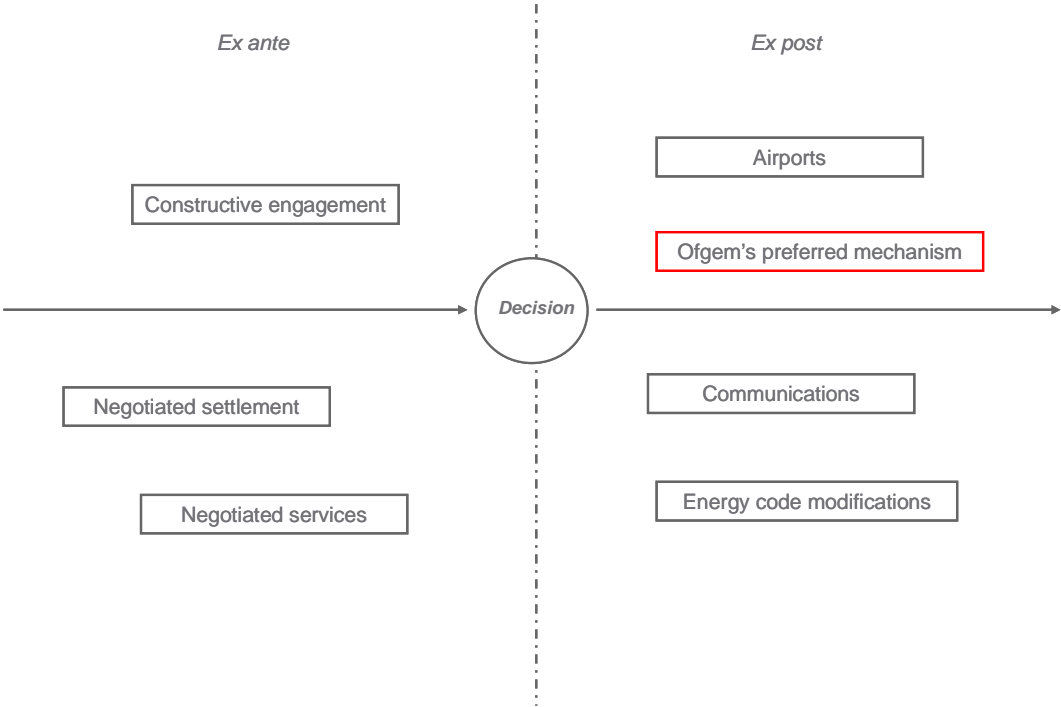
An additional question to add to Ofgem's list would consider the type of appeal mechanism:

- Which appeal mechanism should be utilised?

A distinction needs to be made between different engagement approaches

Different consumer engagement approaches have been adopted across various sectors and jurisdictions. A useful distinction to differentiate between approaches is to categorise them according to when they are employed in relation to the regulator's final determination.

Figure 1: Ex ante and ex post consumer engagement approaches



Source: PA Consulting Group

Under the ex ante approaches, there is active engagement between the network companies and consumer representatives and/or users on price control issues prior to the regulatory determination. This report outlines the key features, and identifies the specific advantages and disadvantages of three ex ante approaches:

- Constructive engagement, which has been adopted by the UK's Civil Aviation Authority;
- Negotiated settlement, which has been adopted in various jurisdictions in North America (e.g. California, Canada, Florida and New York); and
- Negotiated services, a relatively new concept, which has been adopted in Australia.

Under the ex post approaches, there is engagement after the regulator's price control determination, providing consumer representatives and network companies an opportunity to appeal the regulator's price decision. Such approaches could be more accurately described as ex post appeal mechanisms. This report outlines the key features, and identifies the specific advantages and disadvantages of ex post appeal mechanisms in three sectors in Great Britain:

- Airports, where a new appeal mechanism has been scoped out by the Government as part of package of measures intended to modernise the British airport regulatory regime;
- Communications, where an appeal mechanism for any party affected by a range of regulatory decisions including price control determinations is provided for in the Communications Act 2003; and
- Energy Code Modifications, where a right of appeal for people or bodies representing people who are 'materially affected' by a energy code modification has provided for in the Energy Act 2004.

Ex ante approaches have many common disadvantages

In their respective sectors, ex ante approaches to engagement offer a number of advantages over current approaches, having been introduced to address particular issues and concerns. For example, constructive engagement was introduced at a time when the airport sector was facing a number of challenges involving increased investment and rising prices. It was also introduced to address the failings of the current approach which was characterised as adversarial with some parties disengaged from the process. Negotiated settlement approaches were initially introduced in certain North American jurisdictions to save time and money when compared to the traditional litigation approach.

Some of these approaches have been highly successful in delivering substantial benefits for users. However, they are not without flaws and are far from perfect solutions. They have many common disadvantages:

- Final consumers are often not represented in the process, and where they are, consumer representation can be costly;
- The regulator takes on a marginal, peripheral facilitator role, which may be at odds with its principal objectives and purpose;
- There is a disparity in resources between the various parties, with informational advantages in favour of the regulated company and larger users;
- Interests of those who are not represented at the negotiating table (e.g. smaller users, new entrants, final consumers) are not taken into account;
- Two of the approaches (i.e. constructive engagement, negotiated services) have limited track records;
- The regulatory burden on the parties preparing for and engaging in negotiations increases; and
- Wider public interest concerns (e.g. security of supply, sustainability) and future consumers' interests may not be taken into account.

Ofgem's current ex ante approach addresses many of these disadvantages

The British price control regime has provided strong incentives for network companies to deliver significant efficiencies and quality improvements. For example, electricity distribution charges have been halved and transmission charges reduced by 41% since 1990. It is widely recognised the current regulatory framework has been a success. However, the regime is not without its flaws and whilst a number of initiatives have been implemented into the price control consultation stage over the last few years, this could be modified further to deliver an enhanced role for final consumers and users. Such modifications could include:

- The Consumer First Initiative could undertake regular market and consumer surveys, involving a representative sample of consumers, to understand typical consumers' preferences and interests, and how these develop and could provide a useful leading indicator; and
- Drawing on the constructive engagement approach, large users and other relevant parties could be required to outline their requirements, in bilateral discussions with the network company to address confidentiality issues, during the business plan engagement and incentive setting process.

The current ex post approaches employed in other sectors do not provide a clear case for change in the energy sector

Each of the ex post appeal mechanisms considered have disadvantages which do not appear to provide a template for change in the energy sector. These include:

- For some of the approaches, the right of appeal appears to be too wide, which could encourage a broad range of parties, whose interests are not aligned with final consumers, to launch a challenge;
- Some of the approaches may not be adequate enough to deal with full-scale price control investigations; and
- One of the approaches has not been put into practice and therefore there is no practical experience of seeing the mechanism in operation.

However, the British energy sector and the wider economy now faces a critical number of challenges, with the key driver of change being climate change and the rapid move to a low carbon and sustainable economy. With predicted investments of up to £194 billion, such challenges will increase the levels of uncertainty about future network investments and demand by consumers, leading to further complexity and uncertainty associated with Ofgem's price control determinations.

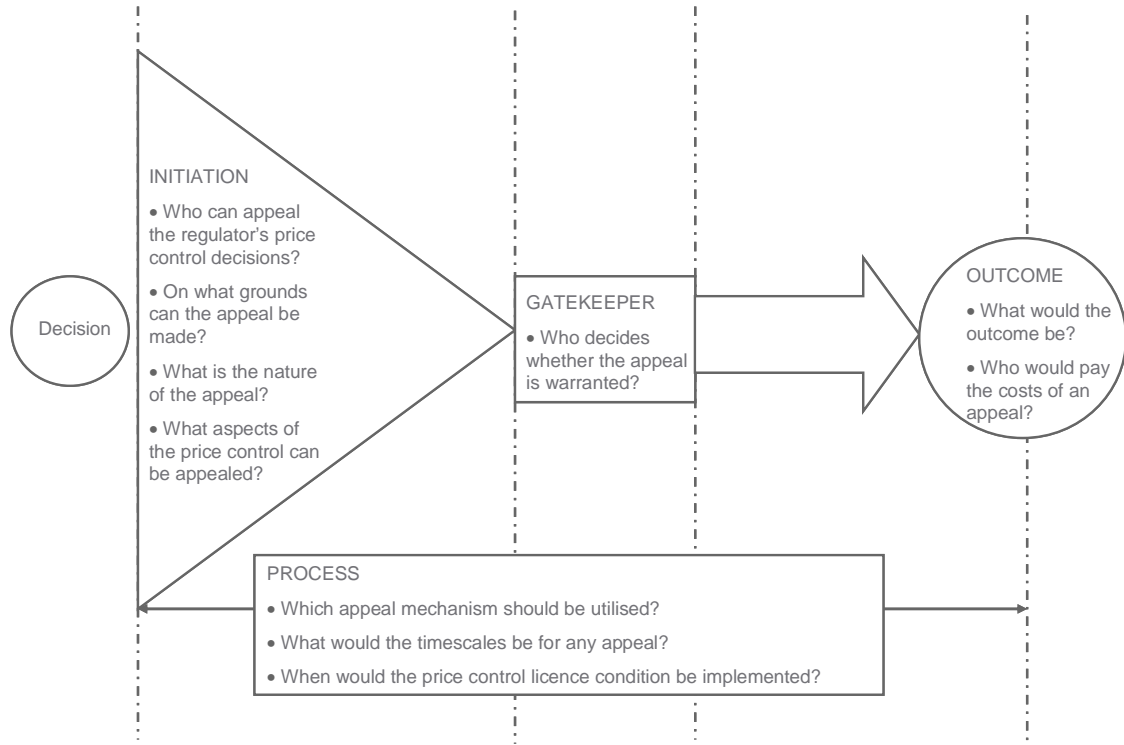
Increasing domestic bills, along with greater awareness of climate change and sustainability issues, will also result in increased consumer engagement on energy-related matters. This raises questions about the current level of consumer participation in the price control process and whether, for transparency, quality and legitimacy of decision-making, appeal rights should be extended to them.

Experience from other British regulated sectors highlights issues that need to be addressed if appeal rights are to be extended to final consumers. In particular, these appeal mechanisms were (or will be, for airports) introduced via primary legislation which allowed for a careful consideration of the issues, and made certain appropriate checks and balances were in place.

An optimal ex post appeal mechanism

There are four distinct elements to an ex post appeal mechanism:

Figure 2: Distinct elements of an ex post appeal mechanism



Source: PA Consulting Group

In designing the most appropriate third party appeal mechanism for Ofgem's final price control proposals, it is useful to start from a first principles perspective, by considering what an effective and efficient mechanism is expected to achieve. There are four objectives the optimal mechanism should meet:

- It minimises unwarranted appeals;
- It minimises direct costs on those involved;
- It minimises uncertainty and risks; and
- It maximises incentives on all parties.

We discuss each of these objectives in turn by outlining how specific elements of the mechanism could be designed to ensure the objective is met.

It minimises unwarranted appeals

This objective ensures frivolous, vexatious, commercially-motivated and unwarranted appeals are kept to an absolute minimum. This is achieved by ensuring only those who represent final consumers' interests can appeal and by making sure the correct incentives are placed on such appellants, so that only warranted appeals proceed.

- How?
 - **Only a designated consumer representatives can launch an appeal.** The primary issue is to establish a system whose principal objective is to protect the interests of the final consumers, whilst minimising unwarranted appeals. It is unlikely individual final consumers will have the resources or expertise to challenge Ofgem's final price control proposals. Consumer representatives, however, would appear to be in a position to develop price control expertise, as demonstrated in other jurisdictions. A designation process, similar to the one employed for 'super-complaints' under the Enterprise Act 2002, would ensure only those representatives that meet certain reasonable consumer-related criteria would be designated to launch price control appeals. Designation would also allow new consumer bodies that are not currently in operation to become designated at some point in the future. Such a system would be flexible enough to take into account a changing consumer representative landscape. The right of appeal would not be extended to other parties, such as network users, who may be affected by a price control decision. Such parties' interests are often not aligned with final consumers; a right of appeal could be utilised to 'game' the system to their own commercial advantage. The proposed airports appeal mechanism has adopted a similar position with respect to airlines, who do not have a right of appeal for the airport regulator's price control decisions.
 - **The nature of the challenge is merits-based.** A process-based mechanism, in the form of judicial review, already exists, which allows final consumers to challenge the process and procedures followed by the regulator in reaching its final price control decision. It therefore appears proportionate and efficient that the appeal mechanism is merits-based. Similar approaches have been adopted in other regulatory sectors, where a merits-based appeal mechanism sits alongside judicial review.
 - **The scope of appeal is either single-issue or full control.** An appeal that is focused on a single-issue is likely to be less resource intensive for all the parties involved. At a first glance, it therefore appears advantageous to limit the scope to a single-issue. However, price control issues are often inter-related and inseparable from one another. For such challenges, the appeal would need to consider the whole package of measures (i.e. full-control) in order to reach a decision. Moreover, limiting the scope may place incentives on certain parties to launch appeals on specific aspects of the price control, even though they are in fact satisfied with the regulator's decision. The scope of appeal also raises questions about the approach employed by the appeal body. The adjudicative approach would appear to be the most suitable for single specific issues, where the focus is on the merits of the regulator's decision; whereas the investigatory approach is better suited to in-depth 'full-control' investigations. On balance, there appears to be some merit in making decisions on this issue on a case-by-case basis, utilising different appeal mechanisms, which would introduce an element of sophistication and flexibility into the appeal mechanism, so that it could adapt to different types of appeal. Such an approach would, however, require legislation to implement and full consultation in order to flesh out and resolve the issues.
 - **The burden of proof is placed on the appellant.** By placing the burden of proof on the appellant during the initiation stage, this should ensure unwarranted appeals are minimised. It would also ensure the correct incentives are placed on consumer representatives when

deciding whether to launch an appeal, so that they take into account the likelihood of a successful appeal.

- **A permission stage separate from the regulator is created.** The gatekeeper needs to make a decision that is fair and balanced and based on the principles of objectivity and transparency. A set of published criteria, along with guidance from the gatekeeper on how it would make decisions would ensure decisions at the permission stage are transparent. Transparency would be reinforced if the gatekeeper also published its decisions and reasoning. Objectivity and robustness would be provided by ensuring the body that decides whether an appeal is warranted is separate and independent from the regulator. For other British regulated sectors, the permission stage is separate from the regulator.

It minimises direct costs on those involved

This objective ensure direct regulatory burdens, in terms of time and cost, are kept to the minimum whilst making sure the appeal body can still carry out its duties and functions effectively. This could be achieved by establishing an appeal mechanism that is flexible enough to deal with different appeals on case-by-case basis, and has clear and transparent guidelines and processes to minimise regulatory uncertainty and delays.

- How?
 - **A flexible approach is adopted, depending on the nature of the appeal.** There appear to be merits in adopting the adjudicative approach for certain single-issue appeals and the investigatory approach for in-depth investigations. As well as introducing an element of sophistication and flexibility into the appeal mechanism, such an approach would be more efficient, particularly for adjudicative appeals where the burden of proof lies with the regulator in terms of justifying its decision. Such an approach will ensure the regulator is incentivised to take into account its objectives and responsibilities when formulating its price control decision.
 - **Clear guidelines and processes, with a specified timetable, are adopted.** Robust and objective guidelines and processes will ensure all parties are aware of their respective roles and responsibilities when an appeal is underway. Guidance could be provided to appellants in terms of type of statement and issues they will need to cover in their challenges and to other parties, in terms of the type of evidence they will required to submit. A specified timetable will ensure certainty and minimise delays.
 - **The appeal body decides the outcome of the appeal.** To minimise direct costs, the appeal body should have the final say on the matter by making a decision on what an appropriate price control modification should be, or, if a single-issue, making a decision on that specific issue. This would also reduce delays in implementing the price control and avoid the need for the regulator to take into account the appeal body's recommendations regarding the price control decision. This streamlined approach would also reduce uncertainty.

It minimises uncertainty and risks

This objective ensures uncertainty and risks are kept to a minimum, which ensures indirect costs, such as impacts on the cost of capital, are also minimised. This is achieved by designing a mechanism that limits unwarranted appeals, is not only streamlined but is effective in reaching its decisions and places the correct incentives on those involved.

- How?
 - **Unwarranted appeals are minimised by a permission stage.** The permission stage should be designed so there is an obligation on the appeal body to carry out an initial assessment of the appeal. This ensures it carefully considers the grounds of the appeal and whether the criteria laid out in the design of the right of challenge are met. An appropriate permission stage

would therefore reduce the risk of unwarranted challenges and minimise appeals to those that are warranted in the first instance.

- **Non-challenged elements of the price control can be implemented.** Delaying the implementation on the price-control could lead to uncertainty and delay in network investments, which could have impacts on security of supply and the ability of the UK to meet its sustainability targets. However, applying any changes following an investigation could be complicated and create its own uncertainties. If only certain specified issues are being appealed, implementing other non-challenged elements may be possible and therefore limit uncertainty. This would need to be undertaken on a case-by-case basis.
- **The appeal has a short fixed timetable.** Having a pre-defined timetable with specified timings for each phase of the appeal would reduce regulatory uncertainty. At a minimum, timings should be set out for each stage and cover: the time between Ofgem's final price control proposals and the deadline by which a consumer appeal has to be lodged; the time the gatekeeper has to make its decision; and the time the appeal body has to reach its decision. The timetable for Energy Code Modifications provides an exemplar of what should be adopted for consumer appeals.
- **The appeal body's staff includes recognised industry experts and commentators.** For those appeals that receive permission to proceed, assurance needs to be provided the challenge will be considered by those who have the relevant expertise and a good understanding of the issues and the sector, providing a degree of certainty in the outcome. The Competition Commission (CC) has a Utilities Panel, consisting of 13 members with utilities expertise and knowledge. Moreover, the CC has conducted numerous price control reviews across various utility sectors. The CC would therefore appear best positioned to deal with consumer appeals.
- **The appeal body decides the outcome of the challenge.** To minimise uncertainty, the appeal body should have the final say on the matter by making a decision on what an appropriate price control modification should be, or, if a single-issue, making a decision on that specific issue. This would also minimise delays in implementing the price control.

It maximises incentives on all parties

This objective ensures all parties face the right incentives not only during the appeal process but during the price control consultation prior to the regulatory determination.

- How?
 - **The optimal design ensures only warranted claims by designated consumer representatives are pursued.** The correct incentives need to be in place to ensure only warranted claims are brought by bodies who strictly represent and whose interests are aligned with final consumers. A designation process will identify those who can appeal on the behalf final consumers. However, the mechanism, whilst having safeguards in terms of the grounds, nature and scope of the appeal, should not prevent warranted appeals. Ensuring the appeal mechanism is effective will make sure the correct incentives are placed on the regulator and network companies, so that they take into account final consumers' (as well as other) interests during the ex ante price control consultation.
 - **Costs of the successful party are, where possible, allocated to unsuccessful party.** The correct incentives need to be placed on the appellant so that they carefully consider whether an appeal is reasonable and has a high probability of success. Allocating the costs of the successful party to the unsuccessful party will ensure appeals are not launched without a compelling case. It will also ensure other parties, such as the regulator and network companies, face strong incentives during the price control consultation to minimise the risk of an appeal by

taking into account consumer interests during the price control consultation. However, for certain appeals (e.g. where the appeal body's final decision does not agree with either the appellant's or regulator's position), it may not always be apparent who the successful and unsuccessful parties are. Under such circumstances, it may be sensible for the appeal body to apportion the costs.

Overall, the optimal design is an appropriate and proportionate appeal mechanism that is effective and efficient. In terms of effectiveness, the mechanism places the right incentives on all parties engaged in the process, including consumer representatives, the regulator, the network companies and other interested parties, by making sure they take into account final consumers' interests. In terms of efficiency, the mechanism is designed in way that minimises regulatory burdens on all parties, whilst making certain warranted challenges can and do proceed.

How Ofgem's appeal mechanism compares

Having scoped out what the ideal ex post appeal mechanism looks like, Ofgem's proposed appeal mechanism is compared with this ideal, as highlighted in Figure 3:

Figure 3: Ofgem's preferred mechanism compared to the ideal

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

Source: Ofgem, Emerging Thinking - Third party right to challenge our final price control decisions, 29th January 2010, Figure 2, p.29 compared to the proposed ideal mechanism

In comparison with the ideal, there are areas of agreement but also areas for disagreement. In terms of areas of agreement, these are as follows:

- **Grounds of challenge:** The grounds for challenge should be 'public interest focus on final consumers'. When the CC considers whether a particular matter operates or may be expected to operate against the public interest, it must have regard to matters covered by Ofgem's statutory duties. This includes whether or not a particular matter is in the interests of current and future

consumers. The grounds for the challenge would therefore be 'there are legitimate concerns that the final price control proposals, the whole package or an element of it, may be expected to operate against the consumer interest'.

- **Nature of challenge:** The nature of the challenge should be 'merits-based', involving a challenge of the rationale of the final control proposals. A process-based mechanism, in the form of judicial review, already exists, which allows challenges on the process and procedures followed by Ofgem in reaching its final price control proposals. It therefore appears proportionate and efficient that the appeal mechanism is merits-based and complements existing processes.
- **Scope of challenge:** The scope of the challenge should either be 'single issue or full control'. On balance, there appears to be some merit in making decisions on this issue on a case-by-case basis, utilising different appeal mechanisms, which would introduce an element of sophistication and flexibility into the appeal mechanism, so that it could adapt to different types of appeal. An appeal that is focused on a single-issue is likely to be less resource intensive for all the parties involved. However, since price control issues are often inter-related and inseparable from one another (e.g. cost of capital issues), appeals which consider the whole package of measures should be allowed. The scope of appeal raises questions about approach employed by the appeal body. The adjudicative approach would appear to be suitable for single issues, where the focus is on the merits of the regulator's decision; whereas the investigatory approach is better suited to in-depth 'full-control' investigations. Such an approach would, however, require legislation to implement and full consultation in order to flesh out and resolve the issues.
- **Challenge timings:** The challenge timings should have a 'timetable for all aspects of the process'. The timetable for Energy Code Modifications provides an exemplar of what should be adopted for consumer appeals. Having a pre-defined timetable with specified timings for each phase of the appeal would reduce regulatory uncertainty. At a minimum, timings should be set out for each stage and cover: the time between Ofgem's final price control proposals and the deadline by which a consumer appeal has to be lodged; the time the gatekeeper has to make its decision; and the time the appeal body has to reach its decision.
- **Implementation of licence change:** 'Non-challenged elements of the licence change should be implemented' where possible. This would need to be evaluated on a case-by-case basis. Delaying the implementation on the price-control could lead to uncertainty and delay in network investments, which could have impacts on security of supply and the ability of the UK to meet its sustainability targets. If only certain specified issues are being appealed, implementing other non-challenged elements may be possible and therefore limit uncertainty. However, we do not believe 'the whole price control should be implemented' since applying any changes following an investigation could be complicated and create its own uncertainties.

There are, however, several areas of disagreement:

- **Who can challenge?:** Only 'parties who apply through a designation process' should be allowed to challenge Ofgem's final price control proposals. Consumer representatives would appear to be in a position to develop price control expertise, as demonstrated in other jurisdictions. A designation process, similar to the one employed for 'super-complaints' under the Enterprise Act 2002, would ensure only those representatives that meet certain reasonable consumer-related criteria would be designated to launch price control appeals. Designation would also allow new consumer bodies that are not currently in operation to become designated at some point in the future. Such a system is therefore flexible enough to take into account a changing consumer representative landscape. The right of appeal would not be extended to other parties, such as network users, who may be affected by a price control decision. Such parties' interests are often not to be aligned with final consumers; a right of appeal could be utilised to 'game' the system to their own commercial

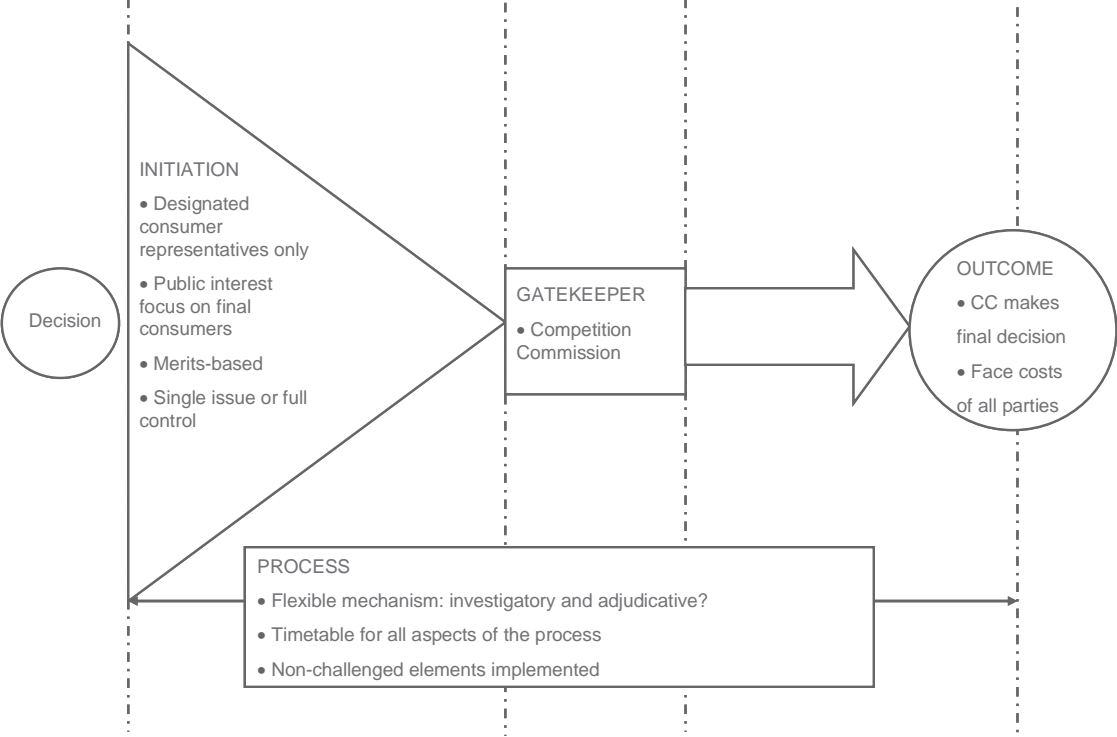
advantage. The proposed airports appeal mechanism has adopted a similar position with respect to airlines, who do not have a right of appeal for the airport regulator's price control decisions.

- **Outcome of CC reference:** The 'CC should make the final decisions on consumer price control appeals'. To minimise direct costs and uncertainty, the appeal body should have the final say on the matter by making a decision on what an appropriate price control modification should be, or, if a single-issue, making a decision on that specific issue. This would also reduce delays in implementing the price control and avoid the need for the regulator to take into account the appeal body's recommendations regarding the price control decision.
- **Awarding of costs:** The unsuccessful party should, where possible, 'face the costs of all parties'. The correct incentives need to be placed on the appellant so that they carefully consider whether an appeal is reasonable and has a high probability of success. Allocating the costs of the successful party to the unsuccessful party will ensure appeals are not launched without a compelling case. It will also ensure other parties, such as the regulator and network companies, face strong incentives to minimise the risk of an appeal by taking into account final consumers' interests during the ex ante price control consultation. However, for certain appeals (e.g. where the appeal body's final decision does not agree with either the appellant's or regulator's position), it may not always be apparent who the successful and unsuccessful parties are. Under such circumstances, it may be sensible for the appeal body to apportion the costs.

An alternative proposal

On the basis of the analysis set out above, the alternative mechanism is illustrated in Figure 4:

Figure 4: An alternative mechanism



Source: PA Consulting Group

Overall, this is the optimal design for an appropriate and proportionate right of appeal that is effective and efficient. It is based on best practice in other British regulated sectors, where such mechanisms have been implemented via primary legislation.

In terms of effectiveness, the mechanism places the right incentives on all parties engaged in the process, including consumer representatives, the regulator, the network companies and other interested parties, by making sure they take into account final consumers' interests.

In terms of efficiency, the mechanism is designed in way that minimises regulatory burdens on all parties, whilst making certain warranted challenges can and do proceed.

Finally, we outline how the alternative mechanism compares to principles of good regulation, as identified by the Better Regulation Taskforce:

Table 1: How the alternative mechanism compares to the principles of good regulation

Transparency	<ul style="list-style-type: none"> • The case for a merits-based appeal rights for final consumers is clear for legitimacy reasons • Consumer representation will ensure the regulator can also focus on its social and environmental objectives • Publication of guidelines, procedures, decisions and underlying reasoning will enhance transparency
Accountability	<ul style="list-style-type: none"> • The appeal mechanism is accessible, fair and efficient • The regulator is incentivised to take into account its statutory duties and objectives; other parties are similarly incentivised to take into account final consumers' interests • Designated consumer bodies will ensure effective representation of final consumers' interests
Proportionality	<ul style="list-style-type: none"> • Direct regulatory burdens on all affected parties are minimised • Uncertainty and indirect costs are minimised by clear timetables, procedures and outcome • The mechanism represents a light but effective appeal process for consumers
Consistency	<ul style="list-style-type: none"> • The mechanism draws on experience and approaches employed in other British regulated sectors • The mechanism complements process-based approaches • The mechanism sits alongside the network company appeal mechanism
Targeting	<ul style="list-style-type: none"> • The mechanism directly addresses the issues i.e. no merits-based appeal rights for final consumers currently exists • The mechanism meets all of its objectives in delivering an efficient and effective mechanism • The mechanism is built from first principles and therefore does not assume existing legislation should not be modified

Whilst some aspects of this alternative appeal mechanism could be introduced under existing legislation (e.g. grounds of challenge), many of the features would require new legislation. It would be inappropriate for a piecemeal approach to be taken where only certain elements of this alternative are implemented. Such an approach would create a second-best appeal mechanism, which would not meet all the inter-related objectives identified i.e. the mechanism should minimise unwarranted appeals, minimise direct costs on those involved, minimise uncertainty and risks, whilst maximising incentives on all involved in price controls.

Moreover, any decision to implement a right of appeal for final consumers must consider the objective and purpose of the regulatory regime established by existing energy legislation. This legislation places Ofgem at the centre of the regulatory framework, giving it a clear purpose and mandate to protect the interests of both existing and future consumers. The implementation of a merits-based appeal rights for final consumers should only take place with the benefit of primary legislation, where issues that require careful consideration are deliberated to make certain appropriate checks and balances are put into place.

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1 Introduction

In this section, we outline why National Grid commissioned PA to consider the advantages and disadvantages of different appeal mechanisms, and, on the basis of this assessment, examine whether a third party right of appeal is required for Ofgem's final price control proposals and if so, what the most effective and efficient mechanism would look like from a first principles perspective. We then set out the structure of this report.

1.1 Context

It is widely recognised that over the last two decades the British price control regime has provided strong incentives for network companies to deliver significant efficiencies and quality improvements. For example, electricity distribution charges have been halved and transmission charges reduced by 41% since 1990¹.

However, the British energy sector and the wider economy now faces a critical number of challenges, with the key driver of change being climate change and the rapid move to a low carbon and sustainable economy. Deployment of new technology such as renewable generation, smart meters and smart grids will involve significant changes and challenges, with predicted investments of up to £194 billion². As a result, domestic bills are expected to increase in real terms between 13% and 23% by 2020 on 2009 levels³. These challenges will increase the levels of uncertainty about future network investments and demand by consumers, leading to further complexity and uncertainty associated with Ofgem's price control determinations.

Increasing domestic bills, along with greater awareness of climate change and sustainability issues, are likely to result in increased consumer engagement on energy-related matters. With network charges representing 17-18% of the domestic bill⁴, this has raised questions about the current level of consumer participation in the price control process and whether, for transparency, quality and legitimacy of decision-making, appeal rights should be extended to them. Others, such as shippers and suppliers, who act as intermediaries between the network companies and final consumers have also suggested they should have a right of appeal, since, they argue, their interests are closely aligned with final consumers.

Ofgem is undertaking a detailed review of how it regulates energy network companies, and in particular, whether the existing 'RPI-X' frameworks remain 'fit-for-purpose'. Ofgem has proposed under any new arrangements, there would be greater emphasis on energy network companies understanding the demands of existing consumers and anticipating what is needed for future consumers. Ofgem has emphasised that enhanced engagement with third parties by network companies and by Ofgem may improve the transparency, quality and legitimacy of decision-making.

¹ Alistair Buchanan Speech at SBGI, Ofgem's 'RPI at 20' Project, 6 March 2008, p. 11

² Ofgem, Project Discovery Options for delivering secure and sustainable energy supplies, 3 February 2010, Figure 3, p.13.

³ Ibid. This excludes one scenario, where domestic bills are expected to increase by 52% by 2016.

⁴ Ofgem, Updated Household energy bills explained, Factsheet 81, 06.08.09, Average figure, broken down as follows: for gas, 2% transmission and 15% distribution; for electricity, 3% transmission and 15% distribution.

To promote and stimulate debate, Ofgem published on 29th January 2010 an 'Emerging Thinking' consultation paper outlining its proposals for a third party right to challenge final price control determinations. Ofgem has developed a potential design for a third party merits-based right of challenge which could be introduced under existing legislation. The paper contains a 'straw man' for the proposed model with variations identified for different aspects of the proposed mechanism.

This report has been produced by PA for National Grid and represents its response to the Third Party Right of Appeal consultation. The report is intended to inform the right of appeal debate drawing on insights and analysis of approaches in other jurisdictions and sectors. In particular, this report examines whether a right of appeal is required and on the basis it is, what the most effective and efficient mechanism would look like from a first principles perspective.

1.2 Structure of this submission

This report constitutes the Final Report of PA's assessment of approaches in other jurisdictions and sectors, based on a literature review and its own experience. On the basis of the specific advantages and disadvantages identified for different approaches, the report examines whether there is a strong case for change. Recognising final consumers should be given a right to appeal, the report then examines what, from a first principles perspective, the most effective and efficient mechanism should look like, drawing on the analysis and insights of other approaches. Finally, comparisons are made with Ofgem's preferred mechanism outlined in its 'Emerging Thinking' consultation paper, before assessing whether the alternative mechanism identified is aligned with the principles of good regulation.

The Final Report is structured as follows:

- **Section 2** distinguishes between ex ante and ex post consumer engagement approaches, basing the categorisation on when the approach is employed in relation to the regulator's final determination. We then outline the ex post appeal mechanisms that are currently in place for Ofgem's final price control proposals before outlining the main elements of Ofgem's proposed third party merits-based right of appeal mechanism.
- **Section 3** outlines the key features of three ex ante approaches that have been adopted in different sectors and jurisdictions. All of these approaches have been examined in detail by other commentators, so the focus is on outlining the specific advantages and disadvantages of each approach, before identifying the common disadvantages associated with all three. Finally, we then assess how Ofgem's current ex ante approach compares and in particular, whether there is a compelling case for change.
- **Section 4** outlines the key features of three ex post approaches, two of which have been adopted in other British regulated sectors, with the other at the proposal stage. We outline the key features, the specific advantages and disadvantages of each approach, before discussing whether any of the approaches provide a compelling case for change in the British energy sector.
- **Section 5** identifies the four distinct elements of an ex post appeal mechanism before outlining, from a first principles perspective, what an effective ex post mechanism would look like, in terms of the objectives it is intended to meet. Having done this, we then compare this ideal with Ofgem's straw man before outlining an alternative mechanism.

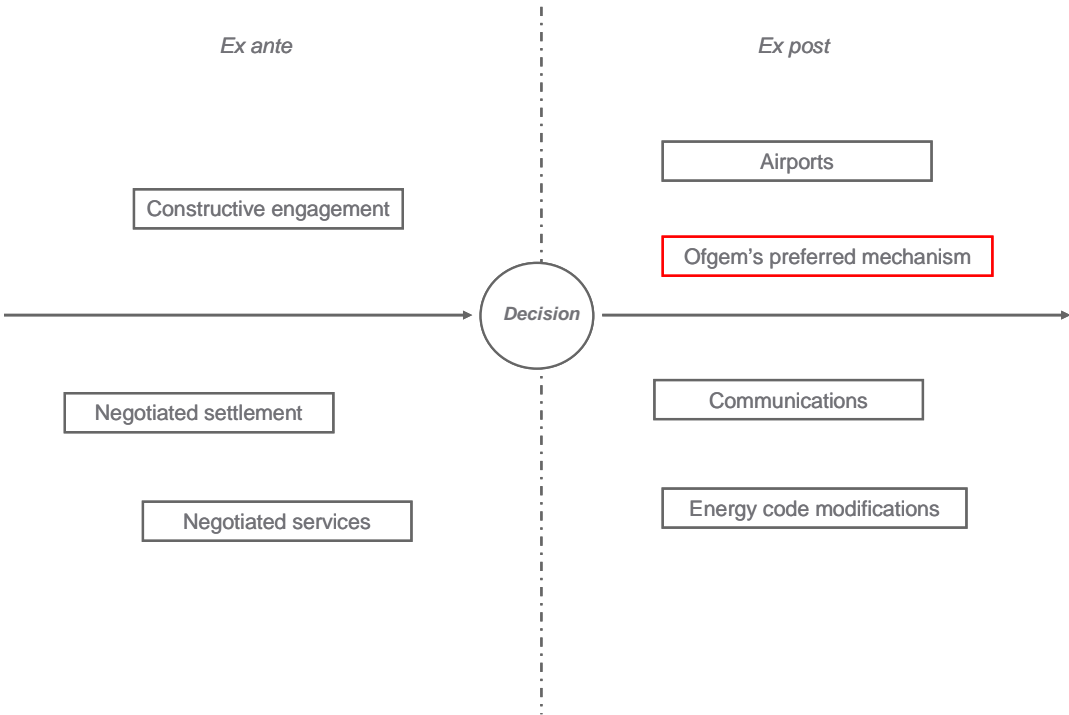
2 A distinction needs to be made between different consumer engagement approaches

In this Section, we distinguish between ex ante and ex post consumer engagement approaches, basing the categorisation on when the approach is employed in relation to the regulator's final determination. We then outline the ex post appeal mechanisms that are currently in place for Ofgem's final price control proposals before outlining the main elements of Ofgem's proposed third party merits-based right of appeal mechanism.

2.1 Ex ante versus ex post consumer engagement approaches

A useful distinction to differentiate consumer engagement approaches is to categorise them according to when they are employed in relation to the regulator's final determination⁵, as shown in Figure 2.1.

Figure 2.1: Ex ante and ex post consumer engagement approaches



Source: PA Consulting Group

⁵ A similar distinction is recognised in a CEPA paper, Consumers' Right to Appeal Regulatory Decisions, Report to Centrica, October 2009

Under the ex ante approaches, there is active engagement between the network companies and consumer representatives and/or users on price control issues prior to the regulatory determination. This report outlines the key features, and identifies the specific advantages and disadvantages of three ex ante approaches:

- Constructive engagement, which has been adopted by the UK's Civil Aviation Authority;
- Negotiated settlement, which has been adopted in various jurisdictions in North America (e.g. California, Canada, Florida and New York); and
- Negotiated services, a relatively new concept, which has been adopted in Australia.

Under the ex post approaches, there is engagement after the regulator's price control determination, providing consumer representatives and network companies an opportunity to appeal the regulator's price decision. Such approaches could be more accurately described as ex post appeal mechanisms. This report outlines the key features, and identifies the specific advantages and disadvantages of ex post appeal mechanisms in three sectors in Great Britain:

- Airports, where a new appeal mechanism has been scoped out by the Government as part of package of measures intended to modernise the British airport regulatory regime;
- Communications, where an appeal mechanism for any party affected by a range of regulatory decisions including price control determinations is provided for in the Communications Act 2003; and
- Energy Code Modifications, where a right of appeal for people or bodies representing people who are 'materially affected' by a energy code modification has provided for in the Energy Act 2004.

2.2 Ofgem's preferred mechanism is an ex post approach

2.2.1 Current appeal mechanisms

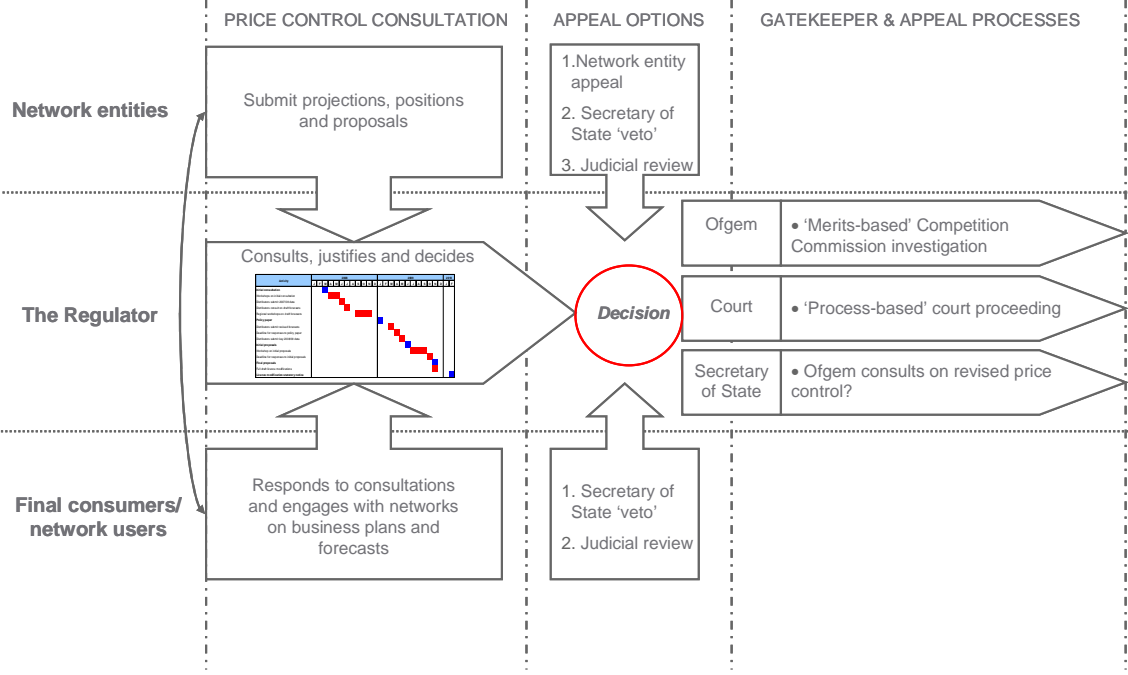
Currently, there are three appeal mechanisms available for Ofgem's final price control proposals:

- Network company 'appeal'⁶;
- Secretary of State 'veto'; and
- Judicial review.

A key feature of these mechanisms is that the two specific to the energy sector have been implemented via primary legislation. Figure 2.2 sets out at high level the various appeal mechanisms currently available to network companies, users and final consumers.

⁶ Initiated by the network company declining Ofgem's final price control proposals.

Figure 2.2: The current price control appeal regime



Source: PA Consulting Group

Network company appeal

Under the Electricity Act 1989 and Gas Act 1986, the price control is implemented by a change to the licence of the licensee i.e. the network company. The network company has to agree the change in licence condition; if they do not, then the matter is referred to the CC by Ofgem.

There have been a relatively low number of appeals since price controls were put in place in the early 1990s⁷. It is arguable that the network company appeal mechanism has incentivised both Ofgem and the network companies to engage constructively during the ex ante price control consultation to ensure the likelihood of an appeal is minimised.

Secretary of State 'veto'

The Electricity Act 1989 and the Gas Act 1986 requires Ofgem to consult with the Secretary of State on licence changes. The Secretary of State has the power direct Ofgem to make modifications which is often referred to as a 'veto'.

Whilst the grounds for intervention are not specified in the Acts, such an appeal could be viewed as ensuring the views of Government and in particular, citizens' interests are taken into account. Indeed, it has been noted by others⁸, that consumers, users and other affected parties could seek the intervention of the Secretary of State if they are not satisfied with Ofgem's price control decision.

So far, the Secretary of State's 'veto' has not been invoked for price control decisions.

⁷ For example, Scottish Hydro-Electric did not agree the change in licence modification implementing the second Distribution Price Control Review in November 1994.

⁸ For example, see CEPA (2009), p.14

Judicial review

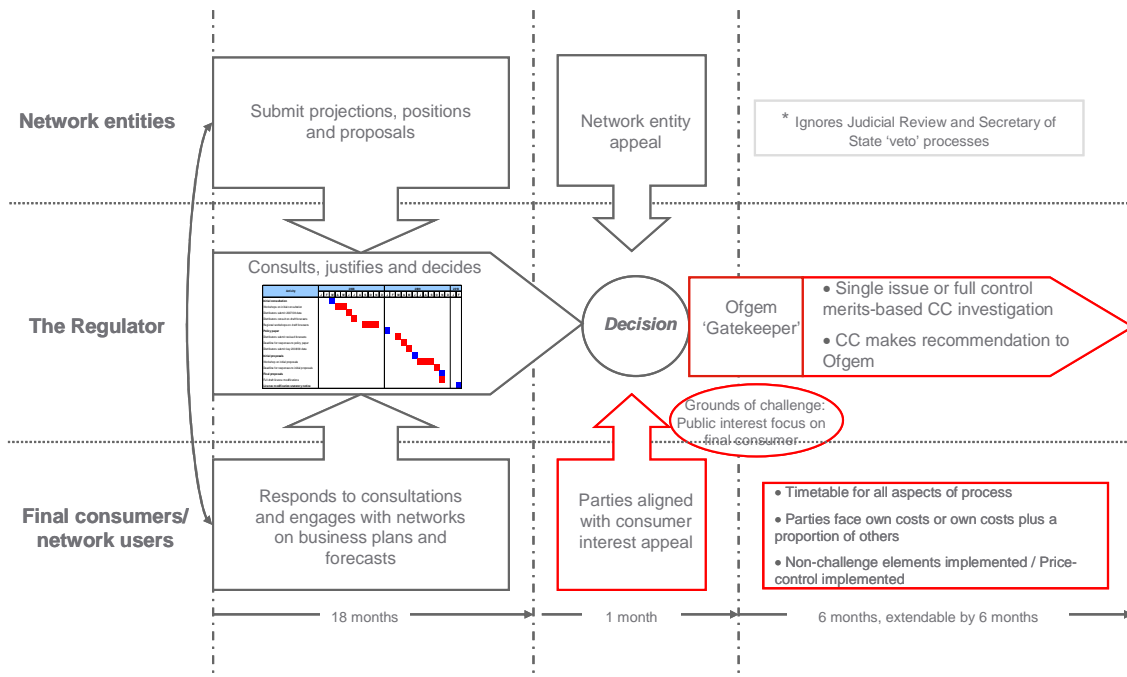
Ofgem's price control decisions are subject to judicial review: a court proceeding in which a judge reviews the lawfulness of the decision. In other words, the judge does not assess the 'merits' of the decision, but whether a reasonable process and correct procedures have been employed by Ofgem in reaching its decision.

Parties adversely affected by a decision by a public body can apply to the Administrative Court for judicial review. For Ofgem's price control decisions this will include network companies, users, such as shippers and suppliers, and final consumers and their representatives.

2.2.2 Ofgem's preferred third party right of appeal mechanism

Ofgem's proposed mechanism set out in its Emerging Thinking consultation paper aims to enhance the rights of final consumers and users after the regulator's price control determination. Figure 2.3 illustrates the proposed enhancements to the price control appeal mechanism.

Figure 2.3: Ofgem's proposed third party merits-based right of appeal mechanism



Source: PA Consulting Group, Ofgem Third Party Right of Appeal Emerging Thinking consultation paper

These changes complement an extensive 18-month plus price control consultation involving the network companies, users and final consumers. This consultation process has been developed over consecutive price controls since the early 1990s, with increasingly transparent and rigorous analysis.

Such a process has come at a cost.

Ofgem requires a significant volume of information to set an appropriate price control, including information on the efficient level of costs; financing costs; future investment needs and customer's preferred price/quality trade off. Ofgem obtains information from companies through submissions from the regulated network companies in a standard format and from periodic information requests, which occur during the price control consultation.

The cost of regulation has increased as the framework has evolved to use more complex incentives and a higher granularity of data for price controls. This is reflected in Ofgem's annual budget which increased fivefold from £16 million to £87 million in 2001⁹, and currently stands at £40 million plus¹⁰. Costs have also increased on those involved in the regulatory process. A National Audit Office report in 2002 found, for the 2000 Distribution Price Control Review, that whilst five companies costs were less than £0.5 million each; three ranged between £0.5 million and £1 million each, with two being over £1 million. Ofgem's costs for the same price control, which included staff and consultancy fees, were estimated to be £2.5 million¹¹.

⁹ Littlechild, S., Negotiated Settlement: a role for American practice in UK policy, 23 February 2007, slide 4 - figures refer to Ofgem and its predecessors, Offer and Ofgas

¹⁰ Ofgem Annual Report 2008-09

¹¹ National Audit Office, Pipes and Wires, April 2002, p. 39

It is recognised, however, that the current framework has been a success:

- Consumers have benefited from significant reductions in the network operator's annual operating expenditures, with electricity distribution network operators reducing operating expenditures by 7.7% in the 11 years to 2003;
- Quality has improved with the achievement of more reliable energy supplies, with 11% fewer cuts and the duration of power cuts falling by 30% in the 15 years to 2005; and
- Investment, at £0.4 billion per year in the 15 years to 2005, has also ensured more secure supplies¹².

¹² All figures quoted from Alistair Buchanan Speech at SBGI, Ofgem's 'RPI at 20' Project, 6 March 2008. pp.11-13.

3 Worldwide different ex ante approaches have been adopted

In this Section, we outline the key features of three ex ante approaches that have been adopted in different sectors and jurisdictions. All of these approaches have been examined in detail by other commentators, so the focus is on outlining the specific advantages and disadvantages of each approach, before identifying the common disadvantages associated with all three. We then assess how Ofgem's current ex ante approach compares and in particular, whether there is a compelling case for change.

3.1 Constructive engagement

3.1.1 Key features

Table 3.1: British airports constructive engagement

Approach	Constructive engagement
Brief description	Regulator proposes at the beginning of the price control a subset of issues it would encourage interested parties to discuss and ideally agree. The agreed outputs from these discussions are fed into the regulator's price control. The regulator sets out its expectations for the process of negotiation, its scope and timings.
Sector employed	British airports
Year approach established	2005
Regulator	Civil Aviation Authority (CAA)
Regulator's principal objective	<p>The CAA has a statutory set of duties and objectives that state that the regulator must perform its functions, including in relation to the setting of designated airports' price caps, in a manner which it considers is best calculated to:</p> <ul style="list-style-type: none"> • Further the reasonable interests of users of airports within the UK; • Promote the efficient, economic and profitable operation of such airports; • Encourages investment in new facilities at airports in time to satisfy anticipated demands by users of such airports; and • Imposes the minimum restrictions that are consistent with performance by CAA of its functions. <p>In December 2009, the Government outlined its proposal to replace the four duties above with a single primary duty:</p> <ul style="list-style-type: none"> • To promote the interests of existing and future end consumer of passengers and freight services at airports in Great Britain, wherever appropriate by promoting effective competition.

Source: CAA website and Department of Transport (2009)

The British airport regulator, the CAA has a statutory responsibility under the Airports Act 1986 to set price controls for airports that are designated by the Secretary of State. There are currently three designated airports: Heathrow, Gatwick and Stansted.

For the first four price controls, the CAA undertook a conventional price control building-block approach, consulting with parties, justifying its decisions on each issue before ultimately reaching its price control conclusions. Before implementing the price cap, the CAA must make a reference to the Competition Commission (CC) unless the Secretary of State directs otherwise. The reference asks the CC to report on what the maximum limit on airport charges for the following period of five years should be, and whether, since the date of the previous reference, the airport has pursued a course of conduct contrary to the public interest. This ex post stage of the price control is in the process of being reformed with, amongst other things, a proposal for a consumer right of appeal to be introduced, which will be discussed further in Section 4.2.

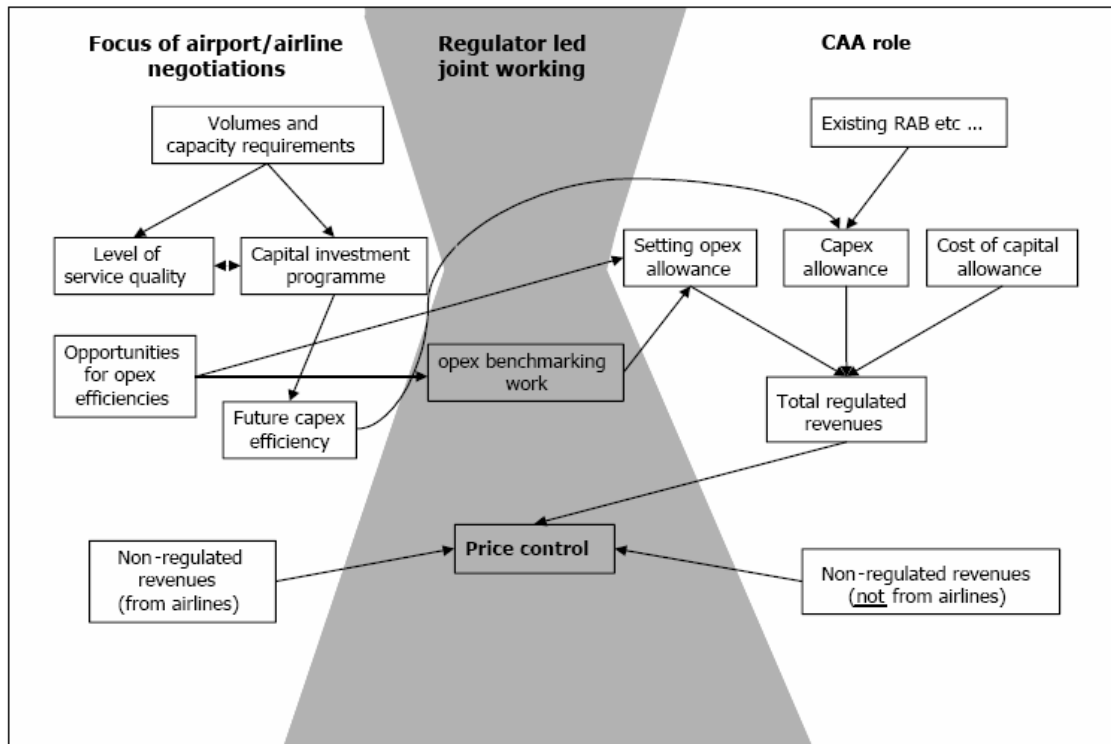
Under the traditional approach, various concerns were expressed about the price control process:

- The sector was moving from a period of declining prices to one with rising airport investment with real price increases of 6.5% per year at Heathrow.
- The CAA also wished to address certain behavioural issues:
 - The process was viewed as adversarial with the airlines and other parties not engaged in the regulatory process, which was at odds with the good commercial relationships between the various parties.
 - It was also felt the focus of the airport operator was wrong. It appeared to be focusing on the regulator rather than taking consumer interests into account as part of its commercial decision-making.
- It was felt the airport operator and airlines should be in a better position than the regulator to discuss and agree volume forecasts, service quality levels and capital expenditure plans.

In May 2004, CAA commenced a consultation about a change in approach for the next regulatory review. CAA proposed that the airlines and airports should engage with each other, and take a more proactive and shared role on certain price control issues.

As a result of this consultation, the CAA identified different elements of the conventional price control building-block approach that could be discussed and agreed separately by airports, airlines and the regulator. Certain elements would be the responsibility of the airports and airlines to discuss and agree; others the joint responsibility of working parties led by the regulator; and a third set would remain the responsibility of the CAA. Figure 3.1 summarises the division of responsibilities.

Figure 3.1: Constructive engagement process



Source: CAA (2005), p. 24

Constructive engagement between the airport operator and the airlines was adopted by the airport regulator, the CAA, in May 2005.

3.1.2 Specific advantages

There are a number of specific advantages of constructive engagement:

- The approach requires **no change to the legislative framework** and can therefore be introduced relatively quickly. CAA consulted on its new approach in May 2004 and after a largely favourable response to its consultation, the approach was adopted a year later in May 2005 for the next price control reviews, although, at the time, guidelines outlining the process of negotiation, its scope and timings had to be developed.
- The approach creates a **precedent** in Great Britain. In this sense, it makes it much easier if an approach is already being utilised in a particular regulated sector so parties can see how it operates in practice, and build on the issues identified and processes that have been adopted. This approach is therefore 'tried and tested'.
- More specifically, the approach **allows parties to constructively engage on issues of importance to them**. For example, where there are shared interests, both sets of parties can constructively engage on a number of issues which are important inputs into a price control, such as volume forecasts, quality of service and capital expenditure plans. Each party can bring its own perspective to the table reflecting its commercial priorities and interests. Such negotiations can be characterised as 'positive-sum', in the sense that both parties can gain from the negotiation. However, those who are not at the negotiating table are often the ones who do not benefit as much, or, at worst, are disadvantaged by the negotiations.

- The approach allows **greater participation in the price control process** where parties directly engage on various issues rather than separately and indirectly with the regulator. This allows the price control process to build on the existing good commercial relationships between the parties. Greater participation could also lead to greater acceptance and 'buy-in' to the regulator's final decision and therefore reduce the likelihood of appeals.

3.1.3 Specific disadvantages

There are, however, a number of specific disadvantages associated with constructive engagement:

- **Both parties must be committed to the discussions** and engage constructively in order to agree the issues. For airports, parties did constructively engage at Heathrow and Gatwick, where there was common ground in recognition that increased capital expenditure was required to alleviate capacity constraints; whereas discussions at Stansted, where the low-cost airlines dominate, were never initiated resulting in the CAA having to step in to determine the price control.
- **Allocation of issues is solely determined by the regulator.** Although CAA consulted on its proposed approach and processes, providing parties with the opportunity to comment on the allocation of issues, under the approach adopted, the regulator ultimately proposes topics for the parties to negotiate, leaving other aspects of the price control its sole domain e.g. cost of capital. The assumption is that the regulator is best placed to assess 'zero-sum' issues.
- There is **uncertainty over 'buy-in' from the regulator** regarding the acceptance of agreements reached between parties. The agreements reached may be in the interests of both parties to the negotiation but may place other non-represented parties at a significant disadvantage (e.g. final consumers, new entrants). Moreover, the regulator may often have other, wider public interest objectives it needs to take into account (e.g. security of supply, sustainability, future consumers' interests). This is likely to create uncertainty regarding the acceptance by the regulator of the decisions reached by the parties.
- There is a **lack of comprehensive procedures and guidelines.** Whilst the CAA did provide guidance on its processes for constructive engagement in its May 2005 document, there have been various criticisms voiced by the parties and the CC regarding the informational advantages enjoyed by the airport operator, BAA over the airlines. Such an advantage allowed BAA to determine when to release information in order to gain control of discussions and to play the airlines against each other to its own advantage. Guidelines prescribing when and to who specific types of information should be released by different parties would address this issue and the CAA appears to be taking steps in this direction.
- There are **no arbitration arrangements if parties fail to agree.** In an attempt to provide the right incentives, the threatened sanction if the parties fail to agree would lead to the regulator stepping in to make decisions. However, there may be situations where an arbitrator could broker a deal. The CAA initially indicated it was reluctant to broker a deal by acting as an arbitrator or broker. However, the subsequent CC investigation of the Stansted price control review recommended the appointment of an independent facilitator.
- **Not all interested parties represented i.e. final consumers, potential new entrants.** Constructive engagement in airports is characterised by discussions between the airport operator and the airlines. Airlines often argue their interests are aligned with final consumers' interests. However, airlines primary interests will be commercially motivated which will often not align them with end users. Moreover, future consumers and new entrants will not be represented at the negotiating table. Whilst the regulator can take these various interests into account, when approving the agreement, this adds a degree of uncertainty.

- Finally, constructive engagement has a **limited track record** of five years. Constructive engagement did fail at one airport meaning the traditional approach had to be adopted by the regulator. Whilst there has now been sufficient time for underlying issues to be identified and steps taken to address them, it is an approach that is still evolving.

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3.2 Negotiated settlement

3.2.1 Key features

Table 3.2: North American Negotiated Settlement

Approach	Negotiated settlement			
Brief description	Regulated utility and interested parties seek to agree on the whole or certain elements of a forthcoming price control, which is then typically adopted by the regulator.			
Country/ State	California	Canada	Florida	New York
Sectors employed	Electric, natural gas, telecommunications, water, railroad, rail transit and passenger transportation companies	Gas and oil	Gas, electric, telephone, water and wastewater	Electric, gas, steam, telecommunications and water utilities
Regulator	California Public Utilities Commission (CPUC)	National Energy Board (NEB)	Public Service Commission of the State of Florida (FPSC)	New York State Public Service Commission (NYPSC)
Year established	1911	1959	1887	1907
Regulator's principal objective	The CPUC serves the public interest by protecting consumers and ensuring the provision of safe, reliable utility service and infrastructure at reasonable rates, with a commitment to environmental enhancement and a healthy California economy.	To promote safety and security, environmental protection and efficient energy infrastructure and markets in the Canadian public interest within the mandate set by Parliament in the regulation of pipelines, energy development and trade.	To facilitate the efficient provision of safe and reliable utility services at fair prices.	To ensure safe, secure, and reliable access to electric, gas, steam, telecommunications, and water services for New York State's residential and business consumers, at just and reasonable rates. The Commission seeks to stimulate innovation, strategic infrastructure investment, consumer awareness, competitive markets where feasible, and the use of resources

				in an efficient and environmentally sound manner.
Consumer advocate	Division of Ratepayer Advocates (an independent arm of CPUC)	-	Office of Public Counsel	Consumer Advocacy Program
Consumer advocate's duty	To obtain the lowest possible rate of service consistent with reliable and safe service levels. In fulfilling this goal, the DRA also advocates for customers and environmental protections.	-	To provide legal representation for the people of the state in utility related matters	-
Year established	-	-	1974	-
Budget, staff	US\$28 million; 140 staff	-	US\$2.5 million; 15 staff	-

Source: CPUC, NEB, FPSC, NYPSC websites

Negotiated settlement has a long history in North America. In the US, settlement procedures were adopted at a federal level in 1949 by the Federal Power Commission (the predecessor to the Federal Energy Regulatory Authority (FERC)). However, it was over a decade before the FPC viewed negotiation between parties as a solution to an increasing backlog of cases and encouraged parties to settle. As a result, between 1961 and 1970, over half (56%) of natural gas pipelines cases at the FPC were settled in whole or part¹³.

The principal reason for introducing negotiated settlement was to save time and money when compared to the traditional litigation approach. The time savings can be significant. FERC reported in 1980 that the average processing time general electric rate cases at FERC was 14 months for an uncontested settlement, 37 months for contested settlements and 50 months (i.e. over 4 years) for fully litigated cases¹⁴. However, other various benefits have been identified, including¹⁵:

- Achievement of results that better serve the needs of the parties;
- Enhanced involvement of the community;
- Reduced court caseloads; and
- Broader access to the justice system.

¹³ See Wang (2004), footnote 4.

¹⁴ See Wang (2004), footnote 13.

¹⁵ Identified in Doucet and Littlechild (2006), pp. 8-9

Looking at a brief history of negotiated settlement in Canada illustrates how it operates, the reasons for its introduction and how the approach can evolve to encourage varied settlements¹⁶.

Established in 1959, the NEB regulates international and inter-provincial oil and gas pipelines in Canada. The traditional rate-of-return regulatory approach involves litigation of each case consisting of testimony, cross-examination and judgement by a court.

The first negotiated settlements put to the NEB were not a unqualified successes. This reflected the NEB's approach at the time where it 'cherry picked' agreements by adjusting the cost of equity downwards. This interference by the regulator post-settlement introduced uncertainty and risks for the parties which, at the time, ultimately dampened the level of settlement activity.

Recognizing that changes were needed to facilitate settlements, the NEB issued Guidelines in 1988. Whilst not initially successful, a cost of capital decision in 1994 along with Revised Guidelines issued in the same year sparked an dramatic increase in the number of settlement. The cost of capital decision fixed the benchmark formula for all companies, removing what was a major source of disagreement between the companies. The 1994 Revised Guidelines also positioned the NEB into a new role as facilitator focused on process and not the merits so that it:

- Normally accepted unopposed settlement: 'consensus of affected parties a good measure of public interest'; and
- Did not judge whether each element is reasonable, but whether the process is open, informed and agreed.

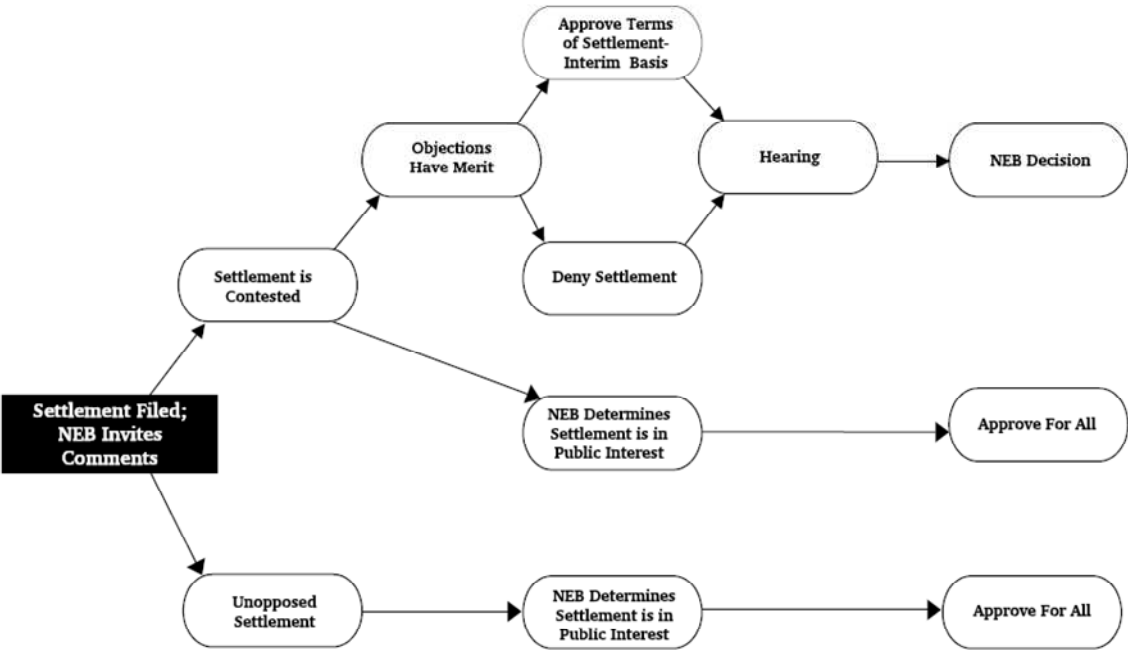
Since 1995, there has been a significant number of settlements, where the scope of settlements has been varied, with agreements on tariffs, operating expenditures, return on equity, service quality and capital expenditure programmes.

One further reform facilitated contested as well as unopposed settlements. 'Contested settlements' are settlements supported by the majority, but are opposed by certain parties. The 1994 Guidelines required settlements to be based on unanimous or unopposed support of the parties. However, at the hearing on TransCanada's application in November 2001, it was recommended the Guidelines be re-examined by the NEB so that it could effectively accommodate applications based on contested settlements. Contested settlements raise potential concerns that opposing parties could be disadvantaged or not benefit significantly from the settlement. The NEB's solution to address such concerns was to approve such settlements on an interim basis, whilst convening a hearing to consider the settlement its entirety. As a result, in 2002, the NEB issued Revised Guidelines to allow contested settlements.

Figure 3.2 illustrates the dual track approach currently adopted for unopposed and contested settlements in Canada.

¹⁶ See, for example, Doucet and Littlechild (2009) for a full discussion on negotiated settlements in Canada.

Figure 3.2: Canadian unopposed and contested negotiated settlements



Source: National Energy Board (2002)

3.2.2 Specific advantages

There are various specific advantages of negotiated settlement, including:

- It has an **extensive track record in North America** being employed at a federal level in US and Canada, and at state level in the US, including California, Florida and New York. It has been successful in reducing the caseload of the courts and it has led to swifter settlements than under the litigation. However, whether it is applicable to jurisdictions outside of North America may be debatable and its success may depend on the specific legal and regulatory frameworks that are in place.
- **Part settlement means not all outstanding issues have to be agreed** by the parties. Parties can negotiate on issues of direct interest and importance to them e.g. tariffs, capital expenditure programmes, which is likely to aid quicker settlement and agreement, assuming the parties to the negotiation have a common interest and there is a shared interest in negotiation.
- The settlement is **flexible and can take different forms**. The scope of settlements can be varied, with agreements in North America involving agreements on a range of issues including tariffs, operating expenditures, return on equity, service quality and capital expenditure programmes.
- There is a evidence of **substantial benefits for users**. It has been noted by commentators that negotiated settlement has benefited end users considerably through lower prices and enhanced service¹⁷, whereby the traditional rate-of-return regulation has been replaced by a form of RPI-X type incentive price caps for specified period of years. The key question when evaluating such benefits is whether negotiated settlement has outperformed RPI-X type approaches or whether it

¹⁷ See, for example, Littlechild and Cornwall (2009), p. 33, where total settlements in Florida amounted to US\$4 billion in the electricity sector.

has just provided a practical and effective solution to the adversarial and time-consuming litigation approach.

3.2.3 Specific disadvantages

Various concerns have been expressed about the merits of negotiated settlement:

- Negotiated settlement is a **costly** approach. Whilst there may be cost savings from the regulator's and court's perspectives, the approach places significant burdens on the parties to the settlement, placing larger well-resourced parties at a distinct advantage. Whilst experience in the US at a federal suggests settlement is shorter than litigation; experience from Canada suggests the opposite i.e. settlement can take longer. Consumer advocates are costly, with the Division of Ratepayer Advocates in California, employing some 140 staff, with a budget of US\$28 million per year. The system therefore, whilst delivering substantial consumer benefits, comes at a cost.
- **Partial settlement may leave certain unresolved issues to the regulator**, with issues such as the cost of capital remaining the realm of the regulator. Such issues are determined by the traditional, longer route of litigation. Experience from Canada suggests decisions on such issues can remove a contentious 'sticking point' from the negotiating table. However, there are questions about how often these issues should be revisited once a decision has been reached in order to take into account changing economic and financial circumstances e.g. a high of cost of capital may need adjusting downwards in a sustained period of slower economic growth. Partial settlement may also not be fully consistent with providing an overall efficiency incentive to the network company.
- The approach **favours large users and final consumers could be worse off**. Large users are likely to be better resourced to negotiate directly and concessions they obtain may be to detriment of those users not at the negotiating table. Whilst certain US states have consumer advocates to address this imbalance, such representation is costly. In other jurisdictions e.g. Canada, the consumer has no direct representation in negotiations. Contested settlements may mean, despite various safeguards, certain parties are disadvantaged or do not benefit as much as others from the settlement.
- Negotiated settlement is **less transparent** than other approaches. Partial settlement on various issues by different parties makes comparisons difficult to make. Whilst various commentators (e.g. Doucet and Littlechild (2009)) have undertaken detailed reviews of the settlements achieved in various jurisdictions, to produce such figures requires detailed understanding of the jurisdiction and the settlements reached.
- The **regulator is not as involved as it should be**. The role of the regulator under negotiated settlement changes dramatically, from a regulator that consults, justifies and decides on the price control for a particular sector or industry to one that facilitates and mediates the process. In other words, the regulator moves from a merits-based authority on the price-control to one that is process-oriented. This change in scope has implications on whether the regulator is fulfilling its principal objectives. A changed role also has implications on the make-up of its staff.
- Finally, **wider public interest concerns may not be taken into account**. Partial settlement means that parties settle on issues of direct relevance to them. Such settlements are likely to be aligned with their own commercial interests which may not align with broader public interest issues such as security of supply and sustainability. Whilst safeguards are in place to ensure the regulator should take these into account, a regulator that has seen its role move from decision-maker to facilitator may mean it is not sufficiently resourced to adequately consider such issues and merely 'rubber-stamp' settlements.

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3.3 Negotiated services

3.3.1 Key features

Table 3.3: Australian negotiated services

Approach	Negotiated services
Brief description	Regulator specifies the criteria for the negotiating framework, with these arrangements applying to individual services or to a subset of services offered by the regulated utility. Regulator/Commercial arbitrator determines unresolved disputes. The regulated utility must set out in compliance statements: its negotiating framework; and the criteria it will apply in treating such services as negotiated services.
Sector employed	Electricity transmission and distribution
Year approach established	2010
Regulator	Australian Energy Regulator (AER)
Regulator's principal objective	To promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to: price, quality, safety, reliability, and security of supply of electricity; and the reliability, safety and security of the national electricity system.

Source: AER website

Negotiated services is a relatively new concept that has been adopted in the Australian electricity transmission and distribution sectors.

The rationale for its introduction at federal level was to replace the differing ad hoc approaches employed by separate state regulators, providing for greater certainty and consistency across all states.

There are three types of negotiated services that a user may request from a network company:

- Connection services including entry, exit and network-to-network connection services;
- Use of system services supplied by the shared network that exceed or are below the networks specified performance standard under any legislation of a participating jurisdiction; and
- Use of system services relating to augmentation or extension of loads of the network.

For transmission, if the user and network company fail to reach agreement, a commercial arbitrator resolves disputes; whereas the regulator determines distribution disputes.

Under the rules, the regulator is required to define the criteria for identifying negotiated services. Regulatory rules also set out the principles for determining terms and conditions.

The regulated utility must set out in compliance statements:

- Its negotiating framework; and
- The criteria it will apply in treating such services as negotiated services.

Overall, according to commentators¹⁸, there are, so far, few instances of this approach being employed.

3.3.2 Specific advantages

There are, in common with the other approaches discussed in this section, distinct advantages to this approach, though at this stage these are purely theoretical:

- Negotiated services **allows for bespoke services and therefore provides an element of flexibility**. Although not as extensive as negotiated settlement, users and network companies have the opportunity to negotiate directly on certain services providing them with the opportunity to reach an agreement on issues where they have common interests.
- The approach **allows choice: users can stipulate quality levels, upgrading services and lower costs**. Users can trade-off quality and cost in order to reach an agreement with the network company. Network companies would also have a greater understanding of users preferences and needs.
- It can also **deliver greater service user engagement**. Users can deal directly with the network company, rather than having to engage with the regulator. Such an approach may be less adversarial and build on existing commercial relationships between the parties.

3.3.3 Specific disadvantages

There are, however, a number of disadvantages to the approach:

- It is a **new untried concept** with, so far, a **very limited track record**. There would appear to be no public domain cases which are available to assess the degree of success for this approach. Some commentators (e.g. Littlechild and Cornwall (2009)) have also suggested that such approach may be of marginal application to Great Britain, where such services are similarly defined.
- The **degree of choice is offset by high level of prescription of the negotiated deal**. The rules relating to negotiated services are highly descriptive with no practical guidelines on how to put into practice being provided by the regulator. The onus is on the regulated network company to prescribe the negotiating framework, which could introducing complexity for users required to understand differing frameworks.
- **Not all interested parties represented**. The implicit assumption is that users interests are aligned with consumers', which may not always be the case, particularly when commercial considerations take priority. Indeed, users may obtain concessions that place others, such as final users, at a distinct disadvantage.

References and Bibliography

Australian Energy Regulator (2007), Call for submissions: Proposed Negotiated Transmission Service Criteria for SP AusNet and VENCORP, June

Australian National Electricity Rules (2010), Version 34, Chapter 6A, Economic Regulation of Transmission Services

¹⁸ Littlechild and Cornwall (2009)

Littlechild, S. and N. Cornwall (2009), Potential scope for user participation in the GB energy regulatory framework, with particular reference to the next Transmission Price Control Review, Report to Ofgem, 28 March, pp. 38-40

3.4 Ex ante approaches have many common disadvantages

Overall, whilst all three of these approaches have distinct advantages there are common disadvantages associated with all three:

- For many of the approaches, **final consumers are often not represented in the process**. The ultimate aim of any approach should be to ensure final consumers benefit from lower prices, enhanced services and innovation. If consumers are not represented in the process, the real risk is that any agreements reached between parties may not be in the wider consumer interest. Users often state they represent the consumer and will have their interests uppermost when negotiating. However, the markets users operate in are often not effectively competitive and therefore incentives to pass-on cost savings negotiated can be reduced. For those markets that are competitive, users principal objective will be to maximise profits; an objective which may not be aligned with consumers' interests. Even for those jurisdictions where the consumer has representative in the negotiation, this comes at a cost, which ultimately the consumer pays for either directly or indirectly e.g. via taxes.
- For all of the approaches, **the regulator takes on marginal, peripheral facilitator role**. The role of the regulator is dramatically different to the RPI-X approach under all three approaches. Under the traditional building-block approach, the regulator consults, builds consensus and justifies its position before ultimately reaching its final decision on the price control. This approach requires in-depth knowledge, expertise and experience in order understand the merits of the case and to get 'buy-in' from various parties which not only includes the regulated network companies, but also users and final consumers. Under the three approaches outlined in this section, the regulator's role shifts dramatically to facilitator, whereby its primary concern is ensuring correct procedures and processes have been followed and complied with. Where a merits-based assessment is required at the end of the process, it would appear the regulator's role is to 'rubber-stamp' the agreement, to the potential detriment of the wider public interest.
- Each approach highlights the **disparity in resources between the various parties**. There is an asymmetry of information in favour of the regulated parties and larger users, which they can use to their advantage in bilateral negotiations. Such an advantage can be used to divide parties and to negotiate agreements that place non-represented parties (e.g. new entrants, smaller users, final consumers) at a distinct disadvantage. In those jurisdictions where consumers have representation, this comes at a cost, since the representative will have to be engage in negotiations for each agreement between the various users and the regulated company.
- Whilst the approaches outlined allow parties to agree on a wide set of issues of direct interest to them, **other parties interests (e.g. smaller users, new entrants, final consumers) are not taken into account**. Where the parties have a common interest there are often strong incentives to negotiate an agreement that is in the interest of both parties. However, those not at the negotiating table may end up being the losers. Other wider public interest considerations may also need to be taken into account. For example, wider long-term concerns about future consumers' interests, security of supply and sustainability are unlikely to be part of the agreement.
- Two of the approaches have a **limited track record**. This is likely to raise questions about their suitability to other sectors and jurisdictions, particularly when they are relatively new concepts which are still evolving. There are also questions about the circumstances of their introduction,

which appears to be a failure of the current regime to deliver substantial benefits for final consumers.

- For all three approaches, **the regulatory burden imposed on parties increases**. The regulatory cost on the parties preparing for and engaging in negotiations is likely to increase and is likely to outweigh the reduced cost of the regulator itself. This will advantage certain parties over others, particularly the regulated company and larger users, who will have the resources and staff to prepare and engage in such negotiations.

3.5 Ofgem's current ex ante approach addresses many of these disadvantages

Over the last two decades the British price control regime has provided strong incentives for network companies to deliver significant efficiencies and quality improvements. It is recognised the current regulatory framework has been a success:

- Consumers have benefited from significant reductions in the network operator's annual operating expenditures, with electricity distribution network operators reducing operating expenditures by 7.7% in the 11 years to 2003;
- Quality has improved with the achievement of more reliable energy supplies, with 11% fewer cuts and the duration of power cuts falling by 30% in the 15 years to 2005; and
- Investment, at £0.4 billion per year in the 15 years to 2005, has also ensured more secure supplies¹⁹.

However, the current ex ante approach employed by Ofgem is not without its flaws and a number of initiatives have been implemented into the price control consultation stage over the last few years which have delivered an enhanced role for both users and final consumers.

3.5.1 Consumer First Initiative

Launched in March 2007, the Consumer First Initiative²⁰ aims is to ensure consumers are at the heart of everything Ofgem does and involves consumer research to inform Ofgem on its key policy decisions, including price control reviews. It involves:

- A Consumer First Panel consisting of 100 domestic consumers meets three times a year to discuss issue on their participation in the market.
- Additionally, a Consumer Challenge Group consisting of six consumer experts provides consumer insights on Ofgem's most complex and high level policy decisions, including price control reviews²¹.

This initiative ensures final consumers are part of the regulator's central decision-making process. It recognises the disparity in resources between the network companies, larger users and final consumers and ensures the regulator takes into account current consumers' interests.

However, it is not without criticism:

¹⁹ All figures quoted from Alistair Buchanan Speech at SBGI, Ofgem's 'RPI at 20' Project, 6 March 2008, pp.11-13.

²⁰ See <http://www.ofgem.gov.uk/sustainability/cp/cf/Pages/CF.aspx> for an overview and associated documentation.

²¹ See, for example, the Consumer Challenge Group's final report on the process and Distribution Price Control Review 5 Final Proposals, March 2010.

- The Consumer First Panel could not claim to be representative on the typical consumer in Great Britain. This could potentially be addressed through market and consumer surveys, involving a representative sample of consumers.
- The frequency of engagement could be increased to produce more accurate understanding of how consumers' preferences and interests develop through time and could provide a useful leading indicator of changing preferences. This could inform future preferences and allow Ofgem to be cognisant of future consumers' interests.

3.5.2 Business plan engagement

For the fifth distribution price control review, distributors were instructed to engage with a wide range of stakeholders in developing their business plans and forecasts²². This involved²³:

- Identifying stakeholder groups and the issues on which they wanted to engage each group;
- Making available user friendly business plans;
- Presenting stakeholders with a range of investment options in a manner so that they can make informed contributions via consultations and workshops;
- Engaging with users and potential users of the networks to better understand future requirements for network capacity; and
- Engaging with input manufacturers and contractors to understand delivery issues and how this may impact on their plans.

This initiative is similar in some respects to the constructive engagement approach, where parties discuss (although not agree on) issues of direct relevance to them. Building on this, rather placing all of the emphasis on the network companies, large users and other parties could also be required to outline their requirements, perhaps in bilateral discussions with the network company to address confidentiality issues.

3.5.3 System Operator (SO) incentive setting process

For the 2008/09 incentive scheme, National Grid Electricity Transmission and National Grid Gas took the lead at the initial proposals stage by:

- Consulting upon its own set of proposals; and
- Holding a series of one-to-one meetings with interested parties and an industry workshop.

Following completion of the initial proposals, Ofgem analysed the forecasts, considered responses from interested parties and then published its final proposals. Overall, the consensus was that this process has been successful and created additional transparency for users²⁴.

Again, in terms of improvements, rather placing all of the emphasis on the network companies, large users and other parties could be required to outline their requirements, again in bilateral discussions with the network company to address issues of confidentiality.

²² See Ofgem (2008), Electricity Distribution Price Control Review Initial consultation document, March, p.2

²³ Ibid, paragraph 4.45, p. 65

²⁴ See Ofgem Letter, National Grid System Operator Incentives from April 2009, 12 May 2008.

3.6 Conclusions

In their respective sectors, ex ante approaches to engagement offer a number of advantages over current approaches, having been introduced to address particular issues and concerns. For example, constructive engagement was introduced at a time when the airport sector was facing a number of challenges involving increased investment and rising prices. It was also introduced to address the failings of the current approach which was characterised as adversarial with some parties disengaged from the process. Negotiated settlement approaches were initially introduced in certain North American jurisdictions to save time and money when compared to the traditional litigation approach.

Some of these approaches have been highly successful in delivering substantial benefits for users. However, they are not without flaws and are far from perfect solutions. They have many common disadvantages:

- Final consumers are often not represented in the process, and where they are consumer representation can be costly;
- The regulator takes on a marginal, peripheral facilitator role, which may be at odds with its principal objectives and purpose;
- There is a disparity in resources between the various parties, with information advantages in favour of the regulated company and larger users;
- Interests of those who are not represented at the negotiating table (e.g. smaller users, new entrants, final consumers) are not taken into account;
- Two of the approaches (i.e. constructive engagement, negotiated services) have limited track records;
- The regulatory burden on the parties preparing for and engaging in negotiations increases; and
- Wider public interest concerns (e.g. security of supply, sustainability) and future consumers' interests may not be taken into account.

The British price control regime has provided strong incentives for network companies to deliver significant efficiencies and quality improvements. For example, electricity distribution charges have been halved and transmission charges reduced by 41% since 1990. It is widely recognised the current regulatory framework has been a success. However, the regime is not without its flaws and whilst a number of initiatives have been implemented into the price control consultation stage over the last few years, this could be modified further to deliver an enhanced role for final consumers and users. Such modifications could include:

- The Consumer First Initiative could undertake regular market and consumer surveys, involving a representative sample of consumers, to understand typical consumers' preferences and interests, and how these develop and could provide a useful leading indicator; and
- Drawing on the constructive engagement approach, large users and other relevant parties could be required to outline their requirements, in bilateral discussions with the network company to address confidentiality issues, during the business plan engagement and incentive setting process.

We note that Ofgem 'do[es] not [...] envisage a model where network companies negotiate directly with other parties on part or all of the overall price control'²⁵. On the basis of the specific disadvantages identified and current ex ante price consultation process, there are currently good reasons not to employ the constructive engagement, negotiated settlement and negotiated services

²⁵ Ofgem (2010), Regulating energy networks for the future: RPI-X@20 Emerging Thinking, 20 January 2010, p. 17, paragraph 3.9.

approaches in the British energy sector. However, the second modification proposed above is aligned with Ofgem's stance that this does 'not preclude any of the parties involved identifying areas where agreement can be reached'²⁶.

²⁶ Ibid.

4 In Great Britain, different ex post approaches have been adopted

In this Section, we outline the key features of three ex post approaches, two of which have been adopted in other British regulated sectors with the other at the proposal stage. We outline the key features, the specific advantages and disadvantages of each approach, before discussing whether any of the approaches provide a compelling case for change in the energy sector.

4.1 Energy code modifications

4.1.1 Key features

Table 4.1: British energy code modifications merits-based appeal mechanism

Approach	Merits-based appeal mechanism
Brief description	<p>The appeal mechanism is a fast and authoritative review by the CC of Ofgem's decision. It has the following key features:</p> <ul style="list-style-type: none"> • It is an appeal: <ul style="list-style-type: none"> – The CC will carry out a merits-based review of Ofgem's decision assessing whether it is right or wrong – In reaching its decision, the CC will not carry out an investigation, or hold what is effectively a re-run of the process by which Ofgem reached its decision. Instead, the CC will review Ofgem's decision. • The appeal is adversarial • The CC must reach its decision within a short period of time
Sector employed	Gas and electricity
Year approach established	2004
Regulator	Ofgem
Regulator's principal objective	<p>To protect the interests of existing and future consumers, wherever appropriate by promoting effective competition. The regulator must when carrying out its functions under each of the Gas Act 1986 and Electricity Act 1989 have regard to:</p> <ul style="list-style-type: none"> • The need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met; • The need to secure that all reasonable demands for electricity are met; • The need to secure that licence holders are able to finance the activities which are the obligations on them; • The need to contribute to the achievement of sustainable development; and • The interest of individuals who are disabled or chronically sick, of

Source: Ofgem and CC websites

The British gas and electricity sectors have in force various industry codes that govern how participants should conduct their business with each other. They cover matters such as use of the system, connection, energy balancing, supply point administration and security of supply²⁷.

A party to a code can seek its modification by putting forward a code modification for consideration within the industry and by a code panel. After consulting within the industry and expert groups, the code panel makes a recommendation to Ofgem as to whether the proposal should be accepted or rejected. Where Ofgem rejects the code panel's majority recommendation on a particular modification, the CC may only allow an appeal if:

- Ofgem failed to have proper regard in carrying out its principal objective and performance of its duties under the relevant sections of the Gas Act 1986 and the Electricity Act 1989;
- Ofgem failed to give appropriate weight to one of the above matters or purposes;
- The decision was based, wholly or partly, on an error of fact;
- The decision was wrong in law.

Once the CC has completed its investigation, the CC has the power to:

- Quash the decision;
- Approve the modification decision;
- Direct that the recommended modification rejected by Ofgem has effect; or
- Remit the decision to Ofgem for reconsideration or determination in line with the CC's directions.

Prior to the implementation of this appeal mechanism, Ofgem's decision was only open to judicial review. The Government consulted on a changed approach for such decisions in 2003 and concluded an appeal mechanism was the appropriate way to improve accountability and transparency of the code modification process. The mechanism was designed to minimise regulatory uncertainty and delay.

The right of appeal is set out in Sections 173-177 and Schedule 22 of the Energy Act 2004 (for the Network Code, the Balancing and Settlement Code and the Use of System Code) and Statutory Instrument 2005 No.1646 of The Electricity and Gas Appeals (Designation and Exclusion) Order 2005 (which covers the other three codes).

The right of appeal is restricted to people or bodies representing people who are 'materially affected' by the decision.

Certain decisions by Ofgem are excluded which are urgent or where delay caused by an appeal could impact in security of supply.

The timetable for such appeals is set out in Figure 4.1:

²⁷ The codes are: for gas, the Supply Point Administration Agreement; the Network Code; and the Uniform Network Code; and for electricity, the Balancing and Settlement Code; the Connection and Use of System Code; and the Master Registration Agreement.

Figure 4.1: Timeline for Energy Code Modification appeals



Source: CC website

The principal stages of the appeal process are:

- **The application for permission:** to bring an appeal, an applicant must obtain permission from the CC. The application for permission must be made within 15 working days of Ofgem's decision and must include, among other things, the applicant's statement of case stating the grounds of appeal and the facts and reasons relied on;
- **The CC's decision on the application for permission:** the CC must decide whether to allow an appeal to proceed within ten working days of the application;
- **Ofgem's reply:** Ofgem must submit its observations on the appeal within 15 working days of the applicant's request for permission; and
- **the CC's decision:** this must be given within 30 working days of the last date that Ofgem could have made its observations on the appeal.

4.1.2 Specific advantages

There are various specific advantages to this appeal mechanism:

- This mechanism creates a useful **precedent in the British energy sector**, with a 'tried and tested' approach. The mechanism minimises regulatory uncertainty and delay, and is designed to take into account other urgent considerations, such as security of supply issues. As it is an appeal mechanism that is already in operation, it is likely to have a significant degree of 'buy-in' and acceptance by the industry.
- This mechanism was **introduced via primary legislation after careful consideration of the issues**. Whilst there were delays as the legislative process took place in order enact primary legislation, it made certain appropriate checks and balances were in place to ensure the appeal mechanism was both accountable and transparent.
- The mechanism has a **comprehensive set of procedures and guidelines** produced by the CC. Such guidelines could be utilised if the approach is adopted for other issues. Again, the existence of such procedures provides a greater degree of certainty for those covered by the mechanism.
- **Certain decisions are excluded if there are impacts on security of supply**. This mechanism has safeguards in place to ensure security of supply considerations are not impacted by appeals. Such safeguards could be extended to include other relevant issues, such as sustainability, and would therefore ensure the appeal mechanism does to materially impact on wider public interest considerations.
- A **separate, independent gatekeeper provides objectivity and transparency**. The CC, which ultimately decides whether to allow an appeal, is the gatekeeper for any challenges. This ensures an independent party assesses whether the appeal should be allowed to proceed. This provides a

strong signal that the mechanism is not subject to regulatory capture and appeals will be assessed independently and on an objective basis.

- **Sensible rules appear to limit frivolous appeals.** The mechanism has been designed to ensure that Ofgem takes into account its principal objectives in reaching its decision on whether to accept or reject recommendation by the code panel. It also ensures the code panel faces similar incentives in reaching its modification recommendation. Where there is challenge and this is warranted, the process is streamlined to ensure a fast and authoritative review by the CC.
- The mechanism has a **short appeal timetable.** A distinct advantage of this mechanism over others is that it has a relatively short 12-week timetable (which is extendable to 14-weeks under certain circumstances). This minimises regulatory uncertainty and delay. It also means the regulatory burden on those involved in the appeal is minimised to a fixed period. Moreover, certain decisions which are urgent or could impact on security of supply are exempt.

4.1.3 Specific disadvantages

Despite the number of specific advantages, this appeal mechanism does have certain disadvantages:

- **All parties with a 'material interest' have the right to appeal.** A broad range of parties can appeal code modifications, with parties having to demonstrate they are materially affected by the decision in order to launch a challenge. This could result in unwarranted appeals, particularly from parties wishing delay modifications due to their own commercial interests. However, allowing materially affected parties to appeal in this case could be viewed as reasonable as the codes are typically agreements between the network companies and major network users.
- **The timetable is too short for in-depth investigation of price control issues.** The mechanism has been designed to deal with specific issues and to assess the merits of the decision rather than being a full-scale inquiry. Whilst such an approach has its advantages, it is unlikely to be suitable for certain appeals, where an in-depth investigation is required. Certain issues will require a full consideration of the issues so that the decision can be fully assessed. For example, cost of capital may be an inappropriate issue to consider under this short process.

References and Bibliography

CC (2005a), Guide to Appeals in Energy Code Modification Cases, July

CC (2005b), The Energy Code Modification Rules, July

CC (2010), Explanatory Notes on section 173 to 177 and Schedule 22 of the Energy Act, link: http://www.competition-commission.org.uk/appeals/energy/energy_act_explanatory_notes.htm

4.2 Airports

4.2.1 Key features

Table 4.2: British airports proposed two-tier merits based appeal mechanism

Approach	Two-tier merits-based appeal mechanism
Brief description	<p>The mechanism has two-tiers:</p> <ul style="list-style-type: none"> • For Tier 1 status (which excludes price control licence modifications)²⁸: <ul style="list-style-type: none"> – All interested parties with a material interest should have standing to appeal, which would expressly include the airports consumer body, Passenger Focus – Appeals should be appealed to the Competition Appeal Tribunal (CAT) – Appeals would be under adjudicative rather than an investigatory appeal framework • For licence modification conditions, including conditions relating to price regulation and/ or service quality <ul style="list-style-type: none"> – Appeals should be appealed to the CC – The airport operator should have to a right to appeal against CAA decisions of licence modifications – A designated passenger body, Passenger Focus, should be given a right of appeal – The right of appeal will not be extended to airlines or other parties who may be affected by the decisions – Appeals would be under investigative procedures based on an assessment of whether the matter operates or may be expected to operate against the public interest
Sector employed	Airports
Year approach established	Draft set of Regulations published for consultation in Summer 2011
Regulator	CAA
Regulator's principal objective	See Section 3.1.1

Source: Department for Transport (2009)

In March 2009, the Government issued a consultation paper outlining its proposals to update and reform the economic regulation of the airport sector in Great Britain²⁹.

The current regulatory regime for airports was established over two decades ago in the Airports Act 1986. Over that period, the sector was liberalised resulting in increasing competition between the airports and airlines. It was also apparent the regulatory framework for airports was lagging behind

²⁸ Licences contain differing levels of obligation for the airport depending on the market power and size of the airport. The highest level of obligation is referred to as Tier 1.

²⁹ Department of Transport, Reforming the framework for the economic regulation of UK airports: A consultation, March 2009

major changes in the statutory framework for other regulated sectors in Great Britain. In particular, under the current framework, judicial review is the only means of challenging regulatory decisions by the CAA.

Recognising this, the Secretary of State for Transport announced a review of the framework of economic regulation of airports in April 2008. One of the principal objectives of the review was to place the interests of consumers at the centre of the regulatory framework. In December 2009, the Government announced a range of measures intended to modernise the airport regulatory regime. The Government announced:

- A new primary duty for the CAA to promote the interests of passengers;
- Enhanced passenger representation through the new role for Passenger Focus in the aviation sector; and
- New rights of appeal for the passenger representative.

The Government recognised the absence of an appropriate merits-based appeal mechanism was a fundamental shortcoming. A two-tier merits-based appeal mechanism was proposed in order to provide checks and balances on the CAA to ensure high quality decision making by the regulator. A distinctive feature of the mechanism is the level of sophistication in dealing with different appeals. For Tier 1 issues, where licensees have enhanced obligations, an adjudicative appeal mechanism will be utilised; for licence modifications, including price control decisions, an investigatory appeal mechanism will apply. Table 4.3 highlights the differing characteristics of the two mechanisms:

Table 4.3: Adjudicative versus investigatory appeals

Investigative approach	Adjudicate approach
<ul style="list-style-type: none"> • The CC will reach its own decision on the issue applying the relevant regulatory duty 	<ul style="list-style-type: none"> • The CC will only assess the merits of the regulator's decision
<ul style="list-style-type: none"> • The CC will consider all evidence that comes to light after the regulator's decision and having received evidence and held hearings with all interested parties. The CC will give directions as to the evidence which it wishes to receive and may commission its own evidence 	<ul style="list-style-type: none"> • The appellant will initiate the appeal by filing a full statement of objections to the regulator's decision and this statement will define the dispute. Evidence that is relevant will be submitted by the parties.
<ul style="list-style-type: none"> • Investigations can be lengthy processes taking between six and twelve months 	<ul style="list-style-type: none"> • Adjudications can occur over a relatively shorter timeframe
<ul style="list-style-type: none"> • Investigations tend to place a significant burden on the regulated company 	<ul style="list-style-type: none"> • The burden falls most heavily on the regulator who has to defend its decision
<ul style="list-style-type: none"> • It is not easy to apply a 'permission stage' to an investigation 	<ul style="list-style-type: none"> • Easier to have a 'permission stage' and hence filter out frivolous claims
<ul style="list-style-type: none"> • It is not easy to award costs against parties as the identification of winners and losers can be difficult 	<ul style="list-style-type: none"> • Easier to identify winners and losers and hence award costs

Source: Department for Transport (2009), paragraphs 6.13 and 6.14

Note: Adjudicative approach re-ordered to make comparison easier with investigative approach. The length of an adjudicative hearing is based on Energy Code Modifications.

The Government's new regulatory regime will require primary legislation to take effect. It is proposed that a draft set of Regulations will be published for consultation in summer 2011.

4.2.2 Specific advantages

There are a number of distinct advantages to this appeal mechanism reflecting the Government's careful consideration of the issues in response to its consultation paper issued last year:

- The mechanism **builds on regulatory frameworks and practice in other regulated sectors in Great Britain**. The two-tier approach has been adopted after considering developments and best practice approaches in other major regulatory sectors in Great Britain, including the energy sector. In this respect the mechanism could be said to represent the Government's current thinking on the most effective and efficient approach to providing final consumers and their representatives with the option to appeal regulatory determinations and ultimately enhance regulatory accountability.
- This mechanism will be **introduced via primary legislation after careful consideration of the issues**. This could mean there are delays during the implementation phase as the legislative process takes place in order enact primary legislation. However, it makes certain appropriate checks and balances are put into place to ensure the mechanism is both accountable and transparent.
- The two-tier approach **appears to be more efficient than other mechanisms**. A 'one size fits all' approach has not been adopted for different kinds of appeal, with the mechanism being flexible enough to utilise either the investigatory or adjudicative approach depending on the issue. The latter approach places the burden on the regulator to defend and justify its decision; whereas the investigatory approach recognises that certain decisions, such as price control decisions, require detailed consideration of various issues. A criticism is that the adjudicative approach could have been adopted for certain specific price control appeals, where the challenge relates to a narrow issue where there is disagreement.
- The **appeal body is independent of the sector regulator**. The CAT and the CC are the appeal bodies for Tier 1 and licence code modification appeals respectively. This ensures appeals are considered by a body that has not been involved in the regulator's decision-making process and can therefore assess the merits of the decision on an independent and objective basis.
- **For price control decisions, only one specified consumer body is given the right to appeal**. This reduces considerably the scope for frivolous and vexatious appeals. It also places a significant responsibility on one consumer representative to ensure it represents the interests all of consumers. By placing it in the spotlight, such a responsibility is likely to ensure it faces the right incentives when deciding whether to appeal as its appeals will be scrutinised if ultimately they are unsuccessful.

4.2.3 Specific disadvantages

The main disadvantage of the airports appeal mechanism, is that it has yet to be implemented and therefore there is no practical experience of seeing the mechanism in operation. The expectation is that these disadvantages are likely to be minimal, although an initial observation is that it did not go far enough in terms of its flexibility. Whilst introducing a level of complexity, it is arguable that the mechanism could have adopted an adjudicative approach for certain price control appeals, where the

appeal is regarding a narrow specific issue which can be separated from the rest of the price control. This should allow relatively short appeals, where the focus of the appeal is to determine whether the correct decision has been reached on a specific issue.

References and Bibliography

Department of Transport (2009), Reforming the Framework for the Economic Regulation of Airports, Decision Document, December

4.3 Communications

4.3.1 Key features

Table 4.4: British communications merits-based appeal mechanism

Approach	Merits-based appeal mechanism
Brief description	<p>Appeals can be made, within a defined timeframe i.e. within 2 months, on the grounds of either:</p> <ul style="list-style-type: none"> • An error of fact; and • An error of law. <p>The CAT makes decisions based on the merits of the case and grounds set out in the notice of appeal. If price control decisions are appealed to the CAT, then this matter must be referred to the CC for determination. The CC price control investigation lasts four months. In its final decision on price control matters, the CAT must follow the CC's determination.</p>
Sector employed	Communications
Year approach established	2003
Regulator	Office of Communications (Ofcom)
Regulator's principal objective	<p>To further the interests of:</p> <ul style="list-style-type: none"> • citizens in relation to communications matters; and • consumers in relevant markets, where appropriate by promoting competition.

Source: Ofcom and CAT websites

In February 2002, the European Parliament and Council of Ministers enacted a number of measures designed to create a common regulatory framework for electronic communications networks and services. A significant number of obligations imposed by those measures on the UK are implemented by provisions in Part 2 of the Communications Act 2003.

Section 192 of the Act introduced an appeal mechanism. As such, any party affected by a range of regulatory decisions taken by the Ofcom may appeal to the CAT. The CAT is an independent judicial body established to hear appeals against certain decisions of the UK competition and sector regulatory authorities. The CAT's decision must include a decision as to what (if any) is the

appropriate action for the decision-maker i.e. Ofcom to make in relation to the subject-matter of the decision under appeal.

For price control matters, the CAT must, before reaching its decision, refer the matter to the CC for investigation. The CC shall determine the price control matter within four months. In its final decision, the CAT must follow the CC's determination. For other matters, cases can take a significant amount of time to complete, as they often raise complicated issues and may involve a significant number of parties. However the CAT does seek to manage the cases tightly and, in general aims, to complete "straightforward" cases in less than nine months.

CAT decisions may be appealed on a point of law to the Court of Appeal or to the Court of Session in Scotland.

The CAT has discretion over whether to award legal cost orders against Ofcom. However, in practice, recent cases have highlighted that CAT is unlikely to award costs unless it is clear Ofcom acted unreasonably or in bad faith.

4.3.2 Specific advantages

There are a number of distinct advantages associated with this appeal mechanism

- This merits-based appeal mechanism creates a **precedent in the British communication sector**, that has been in operation over a number of years. Indeed the Government appears to have considered its merits and disadvantages when formulating the two-tier appeal mechanism for the British airports sector.
- As with the other approaches outlined in this section, this mechanism was **introduced via primary legislation after careful consideration of the issues**. This means there were delays whilst the Government consulted on its approach, justified its decision and enacted primary legislation. However, it made certain appropriate checks and balances were put into place to ensure the appeal mechanism was both accountable and transparent.
- In common with the other ex post approaches outlined in this section, **the appeal body is independent of the sector regulator**. This ensures objectivity and transparency by placing the correct incentives on the regulator to take into account its objectives in reaching its decisions.
- **The appeal tribunal has discretion to award legal costs against the regulator**. Whilst in theory this should reinforce incentives on the regulator to take into account its statutory duties, in practice, the appeal tribunal has so far not awarded costs against Ofcom despite recent cases which found Ofcom's decision to be 'seriously flawed'.
- **For price control matters, the CC investigation is relatively short at four-months**. Whilst a full CC investigation imposes burdens on the regulated companies in terms responding to information requests and preparing for and attending hearings, a shortened timetable of four-months (compared to the usual six-months), reduces some of the burden. However, for other regulatory decisions, appeal hearings can last at least nine months, if not much longer.

4.3.3 Specific disadvantages

- Under this approach, **price control appeals are automatically referred to the CC**. Whilst it appears likely a CC investigation is required for most price control matters, there may be merits of having an adjudicative approach with a fixed timetable for certain price control appeals where the matter is specific and self-contained. There are also strong arguments to remove the CAT totally from the process, which the Government has proposed for airports price control decisions.

- The communications appeal process is **characterised by a large number of appeals**. The mechanism allows parties materially affected by regulatory decisions to appeal to the CAT. Some commentators (e.g. CEPA (2009)) have noted that the number of appeals at over 100 over the last six years is manageable. Whilst very few of these challenges have been appeals against specific price control matters, it does raise questions about the motives of appellants and whether they are using the appeal mechanism to further their own commercial interests. It also raises questions as to whether the right incentives are being placed on the regulator in terms of taking appropriate care, attention and accuracy in its decision-making.

References and Bibliography

CEPA (2009), Consumers' Right to Appeal Regulatory Decisions, Report to Centrica, 14 October, p. 26-27

Competition Appeal Tribunal (2005), Guide to proceedings, October

Office of Communications (2007), Wireless Telegraphy Act licensing manual: a practical user guide to licensing policy

4.4 The current ex post approaches employed in other sectors do not provide a clear case for change in the energy sector

Each of the ex post appeal mechanisms considered has disadvantages which do not appear to provide a template for change in the energy sector. These include:

- For some of the approaches, the right of appeal appears to be too wide, which could encourage a broad range of parties, whose interests are not aligned with final consumers, to launch a challenge;
- Some of the approaches may not be adequate enough to deal with full-scale price control investigations; and
- One of the approaches has not been put into practice and therefore there is no practical experience of seeing the mechanism in operation.

However, the British energy sector and the wider economy now faces a critical number of challenges, with the key driver of change being climate change and the rapid move to a low carbon and sustainable economy. With predicted investments of up to £194 billion, such challenges will increase the levels of uncertainty about future network investments and demand by consumers, leading to further complexity and uncertainty associated with Ofgem's price control determinations.

Increasing domestic bills, along with greater awareness of climate change and sustainability issues, will also result in increased consumer engagement on energy-related matters. This raises questions about the current level of consumer participation in the price control process and whether, for transparency, quality and legitimacy of decision-making, appeal rights should be extended to them.

Experience from other British regulated sectors highlights issues that need to be addressed if appeal rights are to be extended to final consumers. In particular, these appeal mechanisms were (or will be, for airports) introduced via primary legislation which allowed for a careful consideration of the issues, and made certain appropriate checks and balances were in place.

4.4.1 Rights to appeal

If the rights of appeal are too wide, the mechanism can be overwhelmed by a high number of appeals, as illustrated by the experience in the communications sector. This not only increases direct regulatory costs on those involved in the challenges but can lead to greater uncertainty about the regulatory determination process which in turn could delay infrastructure investment.

This issue has been recognised in the airports consumer appeal mechanism where the Government has recognised the legitimacy of ensuring final consumers have a right of appeal, by specifying that one consumer body has the right to appeal the regulator's price control decisions. This not only minimises frivolous, vexatious and unwarranted appeals but also ensures only representatives of final consumers are given such rights. This makes certain other parties do not use the mechanism to their own commercial advantage.

4.4.2 Nature, grounds and scope of the appeal

If the nature, grounds and scope of the appeal are too wide, this could mean existing ex ante processes are not as effective as they should be and the ex post mechanism could become overwhelmed by appeals that are not focused on final consumers or are too broad and include issues that are not the main focus of the appeal. Such an outcome could result in the appeal body by default becoming and being perceived as the regulator.

Experience from other British regulated sectors suggests these concerns are not major issues.

For example, all three are merits-based approaches which sit alongside and complement the existing process-based judicial review, which already allows challenges on the process and procedures followed by the regulator in reaching its final price control proposals.

In terms of the grounds of the appeal, for price control matters, the grounds for challenge for all three approaches are whether a particular matter operates or may be expected to operate against the public interest, which includes consideration of matters covered by regulator's statutory duties. The key issue is whether the regulator's statutory duties include current and future consumers' interests.

However, in terms of the scope of the challenge, all three take an investigatory approach, which is better suited to in-depth inquiries, where the CC considers the whole package of measures. As a result there is no sophistication and flexibility built into the appeal mechanism, with no allowance made for different, less resource intensive, types of appeal, such as single-issue or specific appeals.

4.4.3 'Gatekeeper' needs to be independent

If the gatekeeper is not independent from the regulator, this could result in accusations about the lack of transparency and objectivity. Such accusations could result in process-based appeals, delaying the implementation of price controls and impose burdens, in terms of time and money, on those involved.

The body that hears the appeal in other British regulated sectors is completely separate and independent from the sector regulator. Guidance is published on how decisions are reached in order to promote transparency at the permission stage are transparent. Transparency is further reinforced by publishing decisions and reasoning.

4.4.4 Appeal process should not assume one size fits all

If the appeal process is not flexible, it will impose unnecessary costs on those involved in the appeal, where instead of focusing on a specific issue, the appeal body reopens the whole case in order to

reach its own decision. The traditional approach is for the CC to undertake an in-depth investigation of the price control. For the communications sector, these take four-months; for network company appeals, these can take six months, if not longer, if extended.

There appears merit in making decisions on this issue on a case-by-case basis, which would introduce an element of sophistication and flexibility into the appeal mechanism, so that it could adapt to different types of appeal. An appeal that is focused on a single-issue is likely to be less resource intensive. However, since price control issues are often inter-related and inseparable from one another, appeals which consider the whole package of measures should be allowed. The scope of appeal raises questions about approach employed by the appeal body. The adjudicative approach would appear to be suitable for single, standalone issues; whereas the investigatory approach is better suited to in-depth investigations.

5 Developing an optimal ex post appeal mechanism for energy price control determinations

In this Section, we identify the four distinct elements to an ex post appeal mechanism before outlining, from a first principles perspective, what an effective ex post mechanism would look like, in terms of the objectives it is intended to meet. Having done this, we then compare this with Ofgem's straw man before outlining an alternative mechanism.

5.1 There are four distinct elements to an ex post appeal mechanism

As demonstrated by approaches in other regulated sectors of the British economy, ex post appeal mechanisms have four distinct elements:

- **Initiation:** Once the regulator has reached its final decision on the price control, an appeal may be launched. At the initiation stage, the balance is between ensuring those who have a legitimate concern can appeal, but also making sure frivolous, vexatious, commercially-motivated and unwarranted appeals are minimised. This raises various issues:
 - a. Who can appeal the decision?
 - b. What are the grounds, nature and scope of the appeal?
- **Gatekeeper:** Once an appeal has been launched, it needs to be assessed to see whether it is warranted before proceeding to a full hearing or investigation. This 'permission stage' needs to reach a decision that is fair and balanced where the principles of objectivity and transparency are paramount. The key question for this stage is:
 - a. Who decides whether the appeal is warranted?
- **Process:** Once the appeal has received 'permission' to advance to the next stage, this raises questions about the approach to be employed. The principal issue at this stage is where the burden of proof should lie. Should the regulated company that is the subject of the regulatory decision be required to justify and defend its position on various relevant issues; or should the burden proof be on appellant to justify its appeal and on the regulator to defend its decision? This will have implications on the type of approach to be utilised e.g. investigatory or adjudicative approach, which, in turn will impact on timescales of the appeal. Finally, there are also considerations around implementation of the regulator's decision whilst the appeal is underway. To summarize, the key issues at this stage are:
 - a. Which appeal mechanism should be utilised?
 - b. What are the timescales for the appeal?
 - c. When would the regulatory decision be implemented?
- **Outcome:** The final element of the ex post mechanism is the outcome. The principal issue for the final stage is the nature of the decision by the appeal body and the awarding of costs. Regarding the former, the issue is whether the appeal body should have the final say on the matter or whether it should give recommendations or refer the matter back to the regulator, if it found the appeal to be

justified. In terms of costs, appeals will place burdens on those involved, in terms of legal representation, other advisers and consultants, and senior management and staff time. For unsuccessful appeals, the issue of whether the appellant should face the costs of others becomes relevant. The awarding of costs should be designed to make sure the correct incentives are in place to ensure only warranted appeals come forward. The key questions for this final stage are therefore:

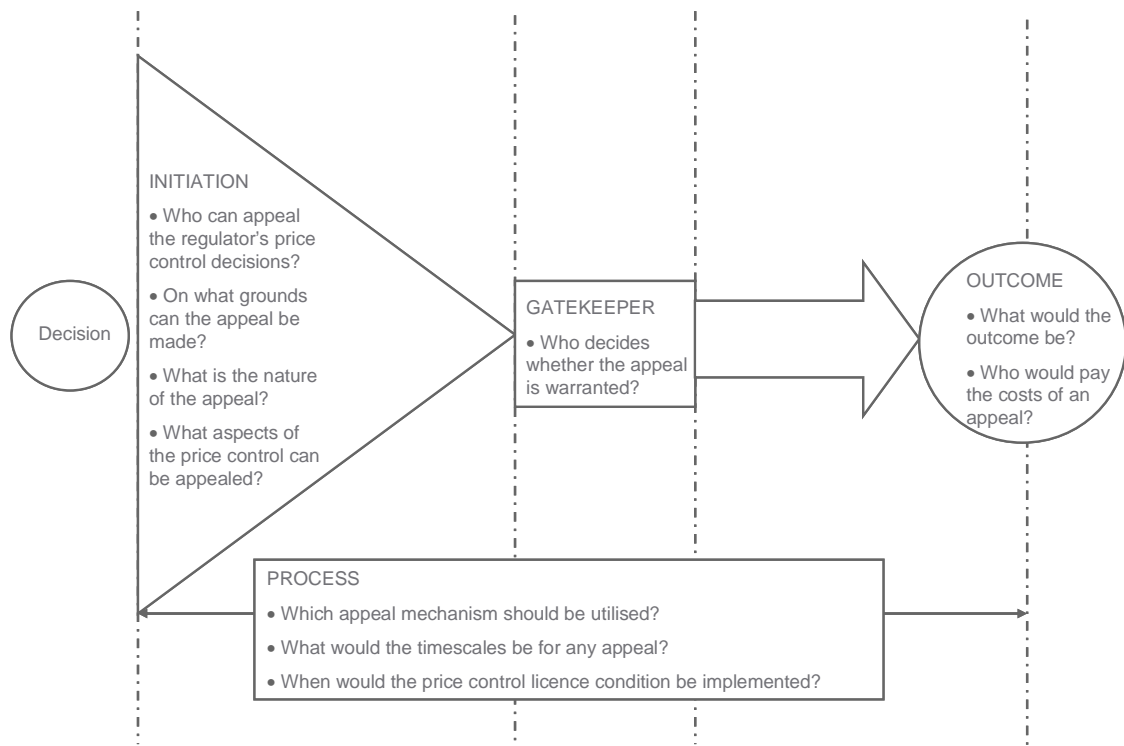
- a. What is the outcome?
- b. Who should pay the costs of appeal?

Overall, therefore the objective in designing an appropriate and proportionate appeal mechanism will be to ensure it is:

- effective i.e. the right incentives are placed on all parties engaged in the process; and
- efficient i.e. the mechanism designed in way that minimises regulatory burdens on all parties.

We have grouped the various questions Ofgem has asked about its proposed appeal mechanism under these four categories (which includes an additional process question regarding the type of appeal to be employed), as illustrated in Figure 5.1:

Figure 5.1: Four distinct elements of an appeal mechanism



5.2 What would an effective ex post appeal mechanism look like?

In designing the most appropriate third party appeal mechanism for Ofgem's final price control proposals, it is useful to start from a first principles perspective, by considering what an effective and efficient mechanism is expected to achieve. There are four objectives the optimal mechanism should meet:

- It minimises unwarranted appeals;
- It minimises direct costs on those involved;
- It minimises uncertainty and risks; and
- It maximises incentives on all parties.

We discuss each of these objectives in turn by outlining how specific elements of the mechanism could be designed to ensure the objective is met.

5.2.1 It minimises unwarranted appeals

This objective ensures frivolous, vexatious, commercially-motivated and unwarranted appeals are kept to an absolute minimum. This is achieved by ensuring only those who represent final consumers' interests can appeal and by making sure the correct incentives are placed on such appellants, so that only warranted appeals proceed.

- How?
 - **Only a designated consumer representatives can launch an appeal.** The primary issue is to establish a system whose principal objective is to protect the interests of the final consumers, whilst minimising unwarranted appeals. It is unlikely individual final consumers will have the resources or expertise to challenge Ofgem's final price control proposals. Consumer representatives, however, would appear to be in a position to develop price control expertise, as demonstrated in other jurisdictions. A designation process, similar to the one employed for 'super-complaints' under the Enterprise Act 2002, would ensure only those representatives that meet certain reasonable consumer-related criteria would be designated to launch price control appeals. Designation would also allow new consumer bodies that are not currently in operation to become designated at some point in the future. Such a system would be flexible enough to take into account a changing consumer representative landscape. The right of appeal would not be extended to other parties, such as network users, who may be affected by a price control decision. Such parties' interests are often not aligned with final consumers; a right of appeal could be utilised to 'game' the system to their own commercial advantage. The proposed airports appeal mechanism has adopted a similar position with respect to airlines, who do not have a right of appeal for the airport regulator's price control decisions.
 - **The nature of the challenge is merits-based.** A process-based mechanism, in the form of judicial review, already exists, which allows final consumers to challenge the process and procedures followed by the regulator in reaching its final price control decision. It therefore appears proportionate and efficient that the appeal mechanism is merits-based. Similar approaches have been adopted in other regulatory sectors, where a merits-based appeal mechanism sits alongside judicial review.
 - **The scope of appeal is either single-issue or full control.** An appeal that is focused on a single-issue is likely to be less resource intensive for all the parties involved. At a first glance, it therefore appears advantageous to limit the scope to a single-issue. However, price control issues are often inter-related and inseparable from one another. For such challenges, the appeal would need to consider the whole package of measures (i.e. full-control) in order to reach a decision. Moreover, limiting the scope may place incentives on certain parties to launch appeals on specific aspects of the price control, even through they are in fact satisfied with the regulator's decision. The scope of appeal also raises questions about the approach employed by the appeal body. The adjudicative approach would appear to be the most suitable for single, specific, issues, where the focus is on the merits of the regulator's decision; whereas the investigatory approach is better suited to in-depth 'full-control' investigations. On balance, there appears to be some merit in making decisions on this issue on a case-by-case basis, utilising

different appeal mechanisms, which would introduce an element of sophistication and flexibility into the appeal mechanism, so that it could adapt to different types of appeal. Such an approach would, however, require legislation to implement and full consultation in order to flesh out and resolve the issues.

- **The burden of proof is placed on the appellant.** By placing the burden of proof on the appellant during the initiation stage, this should ensure unwarranted appeals are minimised. It would also ensure the correct incentives are placed on consumer representatives when deciding whether to launch an appeal, so that they take into account the likelihood of a successful appeal.
- **A permission stage separate from the regulator is created.** The gatekeeper needs to make a decision that is fair and balanced and based on the principles of objectivity and transparency. A set of published criteria, along with guidance from the gatekeeper on how it would make decisions would ensure decisions at the permission stage are transparent. Transparency would be reinforced if the gatekeeper also published its decisions and reasoning. Objectivity and robustness would be provided by ensuring the body that decides whether an appeal is warranted is separate and independent from the regulator. For other British regulated sectors, the permission stage is separate from the regulator.

5.2.2 It minimises direct costs on those involved

This objective ensure direct regulatory burdens, in terms of time and cost, are kept to the minimum whilst making sure the appeal body can still carry out its duties and functions effectively. This could be achieved by establishing an appeal mechanism that is flexible enough to deal with different appeals on case-by-case basis, and has clear and transparent guidelines and processes to minimise regulatory uncertainty and delays.

- How?
 - **A flexible approach is adopted, depending on the nature of the appeal.** There appear to be merits in adopting the adjudicative approach for certain single-issue appeals and the investigatory approach for in-depth investigations. As well as introducing an element of sophistication and flexibility into the appeal mechanism, such an approach would be more efficient, particularly for adjudicative appeals where the burden of proof lies with the regulator in terms of justifying its decision. Such an approach will ensure the regulator is incentivised to take into account its objectives and responsibilities when formulating its price control decision.
 - **Clear guidelines and processes, with a specified timetable, are adopted.** Robust and objective guidelines and processes will ensure all parties are aware of their respective roles and responsibilities when an appeal is underway. Guidance could be provided to appellants in terms of type of statement and issues they will need to cover in their challenges and to other parties, in terms of the type of evidence they will required to submit. A specified timetable will ensure certainty and minimise delays.
 - **The appeal body decides the outcome of the appeal.** To minimise direct costs, the appeal body should have the final say on the matter by making a decision on what an appropriate price control modification should be, or, if a single-issue, making a decision on that specific issue. This would also reduce delays in implementing the price control and avoid the need for the regulator to take into account the appeal body's recommendations regarding the price control decision. This streamlined approach would also reduce uncertainty.

5.2.3 It minimises uncertainty and risks

This objective ensures uncertainty and risks are kept to a minimum, which ensures indirect costs, such as impacts on the cost of capital, are also minimised. This is achieved by designing a mechanism that limits unwarranted appeals, is not only streamlined but is effective in reaching its decisions and places the correct incentives on those involved.

- How?
 - **Unwarranted appeals are minimised by a permission stage.** The permission stage should be designed so there is an obligation on the appeal body to carry out an initial assessment of the appeal. This ensures it carefully considers the grounds of the appeal and whether the criteria laid out in the design of the right of challenge are met. An appropriate permission stage would therefore reduce the risk of unwarranted challenges and minimise appeals to those that are warranted in the first instance.
 - **Non-challenged elements of the price control can be implemented.** Delaying the implementation on the price-control could lead to uncertainty and delay in network investments, which could have impacts on security of supply and the ability of the UK to meet its sustainability targets. However, applying any changes following an investigation could be complicated and create its own uncertainties. If only certain specified issues are being appealed, implementing other non-challenged elements may be possible and therefore limit uncertainty. This would need to be undertaken on a case-by-case basis.
 - **The appeal has a short fixed timetable.** Having a pre-defined timetable with specified timings for each phase of the appeal would reduce regulatory uncertainty. At a minimum, timings should be set out for each stage and cover: the time between Ofgem's final price control proposals and the deadline by which a consumer appeal has to be lodged; the time the gatekeeper has to make its decision; and the time the appeal body has to reach its decision. The timetable for Energy Code Modifications provides an exemplar of what should be adopted for consumer appeals.
 - **The appeal body's staff includes recognised industry experts and commentators.** For those appeals that receive permission to proceed, assurance needs to be provided the challenge will be considered by those who have the relevant expertise and a good understanding of the issues and the sector, providing a degree of certainty in the outcome. The CC has a Utilities Panel, consisting of 13 members with utilities expertise and knowledge. Moreover, the CC has conducted numerous price control reviews across various utility sectors. The CC would therefore appear best positioned to deal with consumer appeals.
 - **The appeal body decides the outcome of the challenge.** To minimise uncertainty, the appeal body should have the final say on the matter by making a decision on what an appropriate price control modification should be, or, if a single-issue, making a decision on that specific issue. This would also minimise delays in implementing the price control.

5.2.4 It maximises incentives on all parties

This objective ensures all parties face the right incentives not only during the appeal process but during the price control consultation prior to the regulatory determination.

- How?
 - **The optimal design ensures only warranted claims by designated consumer representatives are pursued.** The correct incentives need to be in place to ensure only warranted claims are brought by bodies who strictly represent and whose interests are aligned with final consumers. A designation process will identify those who can appeal on the behalf

final consumers. However, the mechanism, whilst having safeguards in terms of the grounds, nature and scope of the appeal, should not prevent warranted appeals. Ensuring the appeal mechanism is effective will make sure the correct incentives are placed on the regulator and network companies, so that they take into account final consumers' (and other) interests during the ex ante price control consultation.

- **Costs of the successful party are, where possible, allocated to unsuccessful party.** The correct incentives need to be placed on the appellant so that they carefully consider whether an appeal is reasonable and has a high probability of success. Allocating the costs of the successful party to the unsuccessful party will ensure appeals are not launched without a compelling case. It will also ensure other parties, such as the regulator and network companies, face strong incentives during the price control consultation to minimise the risk of an appeal by taking into account consumer interests during the price control consultation. However, for certain appeals (e.g. where the appeal body's final decision does not agree with either the appellant's or regulator's position), it may not always be apparent who the successful and unsuccessful parties are. Under such circumstances, it may be sensible for the appeal body to apportion costs.

Overall, the optimal design is an appropriate and proportionate appeal mechanism that is effective and efficient. In terms of effectiveness, the mechanism places the right incentives on all parties engaged in the process, including consumer representatives, the regulator, the network companies and other interested parties, by making sure they take into account final consumers' interests. In terms of efficiency, the mechanism is designed in way that minimises regulatory burdens on all parties, whilst making certain warranted challenges can and do proceed.

5.3 How does Ofgem's proposed appeal mechanism compare?

Having scoped out what the ideal ex post appeal mechanism looks like, Ofgem's proposed appeal mechanism is compared with this ideal, as highlighted in Figure 5.2:

Figure 5.2: Ofgem's preferred mechanism compared to the ideal

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

Source: Ofgem, Emerging Thinking - Third party right to challenge our final price control decisions, 29th January 2010, Figure 2, p.29 compared to the proposed ideal mechanism

In comparison with the ideal, there are areas of agreement but also areas for disagreement. In terms of areas of agreement, these are as follows:

- Grounds of challenge:** The grounds for challenge should be 'public interest focus on final consumers'. When the CC considers whether a particular matter operates or may be expected to operate against the public interest, it must have regard to matters covered by Ofgem's statutory duties. This includes whether or not a particular matter is in the interests of current and future consumers. The grounds for the challenge would therefore be 'there are legitimate concerns that the final price control proposals, the whole package or an element of it, may be expected to operate against the consumer interest'.
- Nature of challenge:** The nature of the challenge should be 'merits-based', involving a challenge of the rationale of the final control proposals. A process-based mechanism, in the form of judicial review, already exists, which allows challenges on the process and procedures followed by Ofgem in reaching its final price control proposals. It therefore appears proportionate and efficient that the appeal mechanism is merits-based and complements existing processes.
- Scope of challenge:** The scope of the challenge should either be 'single issue or full control'. On balance there appears to be some merit in making decisions on this issue on a case-by-case basis,

utilising different appeal mechanisms, which would introduce an element of sophistication and flexibility into the appeal mechanism, so that it could adapt to different types of appeal. An appeal that is focused on a single-issue is likely to be less resource intensive for all the parties involved. However, since price control issues are often inter-related and inseparable from one another (e.g. cost of capital issues), appeals which consider the whole package of measures should be allowed. The scope of appeal raises questions about approach employed by the appeal body. The adjudicative approach would appear to be suitable for single issues, where the focus is on the merits of the regulator's decision; whereas the investigatory approach is better suited to in-depth 'full-control' investigations. Such an approach would, however, require legislation to implement and full consultation in order to flesh out and resolve the issues.

- **Challenge timings:** The challenge timings should have a 'timetable for all aspects of the process'. The timetable for Energy Code Modifications provides an exemplar of what should be adopted for consumer appeals. Having a pre-defined timetable with specified timings for each phase of the appeal would reduce regulatory uncertainty. At a minimum, timings should be set out for each stage and cover: the time between Ofgem's final price control proposals and the deadline by which a consumer appeal has to be lodged; the time the gatekeeper has to make its decision; and the time the appeal body has to reach its decision.
- **Implementation of licence change:** 'Non-challenged elements of the licence change should be implemented' where possible. This would need to be evaluated on a case-by-case basis. Delaying the implementation on the price-control could lead to uncertainty and delay in network investments, which could have impacts on security of supply and the ability of the UK to meet its sustainability targets. If only certain specified issues are being appealed, implementing other non-challenged elements may be possible and therefore limit uncertainty. However, we do not believe 'the whole price control should be implemented' since applying any changes following an investigation could be complicated and create its own uncertainties.

There are, however, several areas of disagreement:

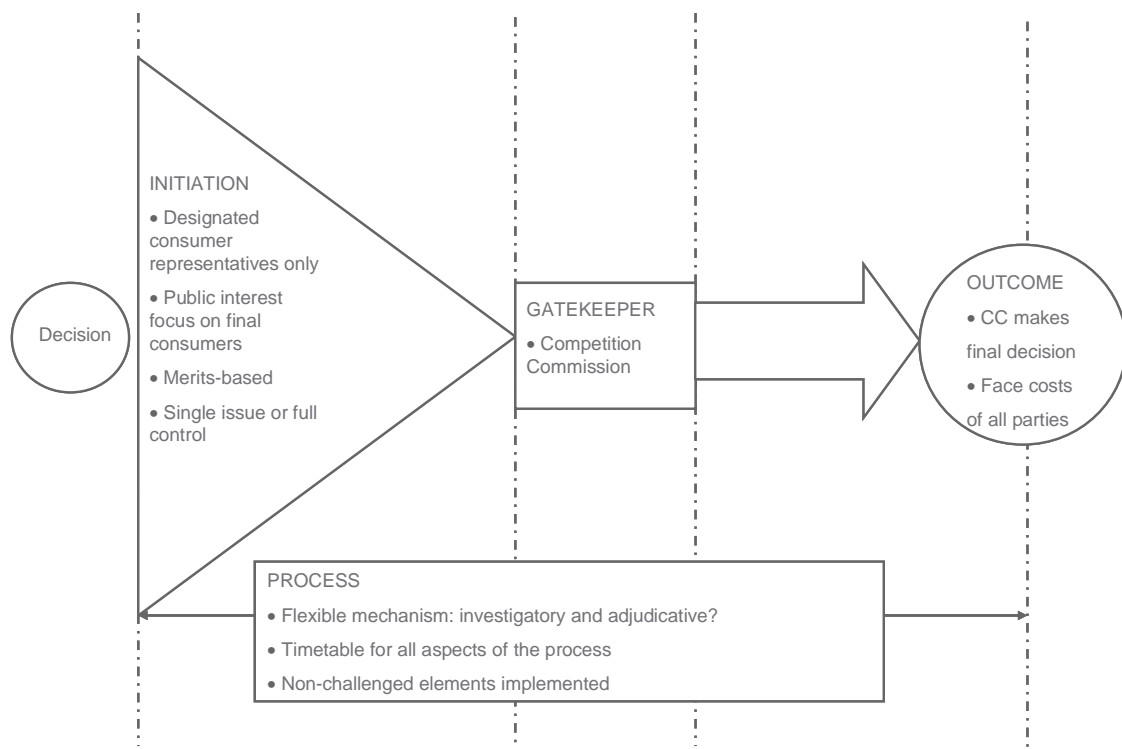
- **Who can challenge?:** Only 'parties who apply through a designation process' should be allowed to challenge Ofgem's final price control proposals. Consumer representatives would appear to be in a position to develop price control expertise, as demonstrated in other jurisdictions. A designation process, similar to the one employed for 'super-complaints' under the Enterprise Act 2002, would ensure only those representatives that meet certain reasonable consumer-related criteria would be designated to launch price control appeals. Designation would also allow new consumer bodies that are not currently in operation to become designated at some point in the future. Such a system is therefore flexible enough to take into account a changing consumer representative landscape. The right of appeal would not be extended to other parties, such as network users, who may be affected by a price control decision. Such parties' interests are often not to be aligned with final consumers; a right of appeal could be utilised to 'game' the system to their own commercial advantage. The proposed airports appeal mechanism has adopted a similar position with respect to airlines, who do not have a right of appeal for the airport regulator's price control decisions.
- **Outcome of CC reference:** The 'CC should make the final decisions on consumer price control appeals'. To minimise direct costs and uncertainty, the appeal body should have the final say on the matter by making a decision on what an appropriate price control modification should be, or, if a single-issue, making a decision on that specific issue. This would also reduce delays in implementing the price control and avoid the need for the regulator to take into account the appeal body's recommendations regarding the price control decision.
- **Awarding of costs:** The unsuccessful party should, where possible, 'face the costs of all parties'. The correct incentives need to be placed on the appellant so that they carefully consider whether an appeal is reasonable and has a high probability of success. Allocating the costs of the

successful party to the unsuccessful party will ensure appeals are not launched without a compelling case. It will also ensure other parties, such as the regulator and network companies, face strong incentives to minimise the risk of an appeal by taking into account final consumers' interests during the ex ante price control consultation. However, for certain appeals (e.g. where the appeal body's final decision does not agree with either the appellant's or regulator's position), it may not always be apparent who the successful and unsuccessful parties are. Under such circumstances, it may be sensible for the appeal body to apportion the costs.

5.4 An alternative proposal

On the basis of the analysis set out above, the alternative mechanism is illustrated in Figure 5.3:

Figure 5.3: An alternative mechanism



Source: PA Consulting Group

Overall, this is the optimal design for an appropriate and proportionate right of appeal that is effective and efficient. It is based on best practice in other British regulated sectors, where such mechanisms have been implemented via primary legislation.

In terms of effectiveness, the mechanism places the right incentives on all parties engaged in the process, including consumer representatives, the regulator, the network companies and other interested parties, by making sure they take into account final consumers' interests.

In terms of efficiency, the mechanism is designed in way that minimises regulatory burdens on all parties, whilst making certain warranted challenges can and do proceed.

Finally, we outline how the alternative mechanism compares to principles of good regulation, as identified by the Better Regulation Taskforce:

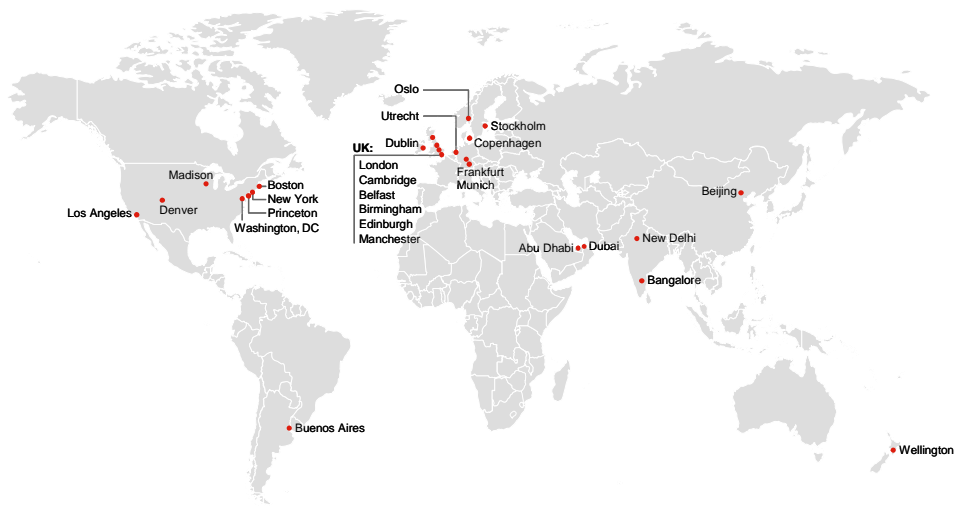
Table 5.1: How the alternative mechanism compares to the principles of good regulation

Transparency	<ul style="list-style-type: none"> • The case for a merits-based appeal rights for final consumers is clear for legitimacy reasons • Consumer representation will ensure the regulator can also focus on its social and environmental objectives • Publication of guidelines, procedures, decisions and underlying reasoning will enhance transparency
Accountability	<ul style="list-style-type: none"> • The appeal mechanism is accessible, fair and efficient • The regulator is incentivised to take into account its statutory duties and objectives; other parties are similarly incentivised to take into account final consumers' interests • Designated consumer bodies will ensure effective representation of final consumers' interests
Proportionality	<ul style="list-style-type: none"> • Direct regulatory burdens on all affected parties are minimised • Uncertainty and indirect costs are minimised by clear timetables, procedures and outcome • The mechanism represents a light but effective appeal process for consumers
Consistency	<ul style="list-style-type: none"> • The mechanism draws on experience and approaches employed in other British regulated sectors • The mechanism complements process-based approaches • The mechanism sits alongside the network company appeal mechanism
Targeting	<ul style="list-style-type: none"> • The mechanism directly addresses the issues i.e. no merits-based appeal rights for final consumers currently exists • The mechanism meets all of its objectives in delivering an efficient and effective mechanism • The mechanism is built from first principles and therefore does not assume existing legislation should not be modified

Whilst some aspects of this alternative appeal mechanism could be introduced under existing legislation (e.g. grounds of challenge), many of the features would require new legislation. It would be inappropriate for a piecemeal approach to be taken where only certain elements of this alternative are implemented. Such an approach would create a second-best appeal mechanism, which would not meet all the inter-related objectives identified i.e. the mechanism should minimise unwarranted appeals, minimise direct costs on those involved, minimise uncertainty and risks, whilst maximising incentives on all involved in price controls.

Moreover, any decision to implement a right of appeal for final consumers must consider the objective and purpose of the regulatory regime established by existing energy legislation. This legislation places Ofgem at the centre of the regulatory framework, giving it a clear purpose and mandate to protect the interests of both existing and future consumers. The implementation of a merits-based appeal rights for final consumers should only take place with the benefit of primary legislation, where issues that require careful consideration are deliberated to make certain appropriate checks and balances are put into place.

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