Inveralmond House
200 Dunkeld Road
Perth PH1 3AQ

Hannah Nixon
Partner, RPI-X@20 and Regulatory Finance
The Office of Gas and Electricity Markets
9 Millbank
London SW1P 3GE

Tel: 01738 456400

Fax: 01738 456415

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Dear Hannah,

Regulating Energy Networks for the Future: RPI-X@20 - Emerging Thinking.

Thank you for the opportunity to comment on the above consultation on RPI-X@20 – Emerging Thinking. We have responded separately to the associated consultation documents: Embedding Financeability in a New Regulatory Framework; and, Third Party Right to Challenge. We would also commend and support the response submitted by the Energy Networks Association on the Emerging Thinking document on behalf of the energy network operators (NWO).

Overall, we support much of the direction of the Emerging Thinking conclusions i.e. an enhanced ex ante regulatory framework, and the rejection of both ex post regulation and more radical reforms. This approach builds on the proven success of the RPI-X@20 methodology, as it has developed since privatisation.

However, we do have major concerns with regard to the proposals to allow a third party right of challenge (which we do not believe adds any real value for customers and will effectively undermine Ofgem's review process) and with the financeability "strawman" (which, in our view will undermine investment and risks Ofgem effectively determining company financial structures). We have set out our opposition to these proposals in our separate responses.

We would summarise the key features of the Emerging Thinking proposals, under an enhanced ex ante framework, as moving to a more "contractual" relationship between NWOs and the Regulator, including:

- "Richer" business plans (i.e. more elaborate, longer-term, scenario-based and bespoke business plans);

- Output-based price control settlements – including explicit identification of the outputs that NWOs will be expected to deliver as part of the regulatory "contract";
- Increased stakeholder engagement in the price control review process – including the potential right for third parties to appeal price control settlements to the Competition Commission; and
- Longer-term or partial longer-term price controls.

The above features are then tempered with a number of potential "incentives" aimed, as far as we can see, at encouraging NWO behaviour that is consistent with Ofgem's view of what is in the interests of customers, both current and future customers.

These measures include:

- Differential rates of return within sector – including "reward" for consistent delivery of outputs;
- Differential levels of regulatory scrutiny depending upon NWO's historical performance;
- Equalisation of incentives between capex and opex solutions – to encourage consideration of solutions which avoid investment in "hard" assets;
- Competitive tendering of projects and encouragement for ESCOs – seemingly intended as a penalty for not agreeing network access terms; and
- A specific innovation stimulus – to supplement IFI.

We note that all of the above, when taken as a whole, lead to additional complexity in the regulatory framework, and that increased complexity was one of the perceived drawbacks with the current regulatory framework when the RPI-X@20 project was first announced. There is, therefore, a balance to be reached with enhancing the regulatory framework and the potential complexity of the future regime and Ofgem should bear this in mind when developing further its preferred options.

<u>Business plans</u>.

As we have said above, we support an enhanced ex ante framework and recognise that "richer" business plans are part of that framework. Indeed, we believe that longer-term business plans are the right move for the industry as a whole.

We also support the opportunity to arrive at a price control settlement more suited to a network's particular circumstances. However, we note that this might make comparative regulation more difficult when each comparator has a company-specific settlement. Comparative benchmarking has served customers well to date and it will therefore be necessary to ensure that the new framework preserves incentives for efficiency.

<u>Outputs</u>.

Again, we recognise that more output-focused settlements are part of an enhanced ex ante framework and seems a progressive enhancement.

However, the development of output measures will need careful consideration. Clearly, each sector will have its own issues, for example an asset utilisation output measure will be a particular challenge in electricity transmission. Overall, it will be important to ensure that future output measures are meaningful, measurable and achievable but without being over-prescriptive and running the risk of the businesses being "micro-managed" by the Regulator. It will also be necessary to ensure that the output measures to which companies are exposed are controllable. For example, exposing transmission companies to an output measure based on utilisation of new capacity would result in the licensee facing the same risks as windfarms and hence would require similar returns.

Stakeholder engagement.

Service is one of our core values and as such we are committed to ensuring full stakeholder participation throughout the price control review process to allow consumers' views to be fully discussed and taken into account in the price control decision. To this end, we fully support the stakeholder engagement incentives introduced in DPCR5 and the proposed extension of those proposals to transmission and gas networks. It is, in our view, the right thing for a NWO to be doing and is a far more proportionate solution than alternatives proposed such as constructive negotiation.

However, we are firmly opposed to the proposal to introduce a third party right of appeal of a price control decision to the Competition Commission, as we believe this will cause an unacceptable level of uncertainty in the price control process without adding any real value to consumers. We also consider that more stakeholder engagement puts a greater responsibility on Ofgem to accept company business plans where it can be demonstrated that there has been vigorous testing with relevant stakeholders. In this context, we would note that suitable engagement for network companies should involve final customers, not just suppliers.

Longer-term price controls.

It is, in our view, the wrong time to be considering longer-term price controls, in general, while there is considerable economic and political uncertainty. For example, extending price control periods to, say, 10 years, would add significant business risk as, at the current time, it is almost impossible to foresee what our costs might be in 10 years time. Indeed, Ofgem has recognised this with suggestions that partial "reopeners" be provided mid-term to mitigate concerns that there could be changes in the outputs/outcomes required of the networks, or changes in the economic environment within which the networks operate during the longer term price control period. However, in our view, if Ofgem were to pursue this approach it would result in considerable uncertainty and regulatory risk that would outweigh any potential benefit of a longer term settlement.

That said, there my be a case for partial longer-term arrangements where workloads are better defined. For example, in gas distribution networks, repex workloads are known, in general, a long way ahead and a longer-term settlement might be efficient and allow more flexibility. Even in these circumstances, there would still be a need to periodically review unit cost allowances.

We can see that altering periods by a year has been used in the past, and might be acceptable in the future, as a way of managing price control review workloads between sectors.

Rates of return.

We have responded in detail on financeability issues in our response to the associated Emerging Thinking financeability consultation.

In summary, we believe that the RPI-X@20 Emerging Thinking proposals, if implemented, put significant upward pressure on NWOs' cost of capital and, hence, costs to customers, and this would need to be reflected in price control settlements going forward.

While we can see a case for differential rates of return between sectors, (for example, the potential for discrete packages of investment e.g. TIRG, to have longer payback periods with an associated premium return) we cannot support differential/ company-specific WACC within sector.

Equalisation of incentives.

During DPCR5, SSE made clear its strong opposition to the introduction of "balanced" or "equalised" capex/opex incentives. In our view, the full implications of this approach have not been adequately considered, especially the "odd" incentive properties and their influence on NWO behaviour. It is also clear that equalisation of incentives will just not work in transmission given the relative scale of capex and opex.

A prime concern to us, arising in Emerging Thinking, is the implicit assumption that capitalisation rates (through moving to equalised capex/ opex incentives), rather than depreciation, become Ofgem's "preferred" financeability adjustment. This change simply adds another variable, contributing to uncertainty and weakening the incentive to invest.

We are also concerned that Ofgem has automatically assumed that "one size fits all" when seeking to replicate the equalised incentives policy across all networks. We do not believe that this is the case and Ofgem should, at the very least, consider the merits (or otherwise) of extending this principle to other network sectors on a case by case basis.

We note that Ofgem recognises that equalisation of incentive rates between capex and opex will not, in itself, eliminate distortions to the incentives to choose opex or capex solutions. In particular, Ofgem recognises that distortions can arise from using different methodologies. Ofgem will also be aware of the problems of benchmarking total (operating and capital) expenditure, especially in the context of different measures of capital stock. In our view, these issues merit further consideration by Ofgem before seeking to extend the policy to any other network group.

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

Access.

We welcome that the Emerging Thinking document has stepped back from a more radical extension of tendering of what are rightly NWO functions. We endorse the need not to delay delivery of investment needed to meet Government targets and as such agree that any move to tender certain aspects of a NWO function should not, in any way, jeopardise timely delivery of investment. We also note that competitive tendering of network operations has proved difficult, and has experienced considerable problems, in many industries (including, in the energy sector, developing OFTOs). Finally, it is not efficient to force competitive tendering, as there needs to be a balance between internal and external sourcing and, in our view, it is best left to the NWOs to manage that balance.

Ofgem has raised the profile of ESCOs in its Emerging Thinking document. However, the context within which it has been raised is more about third party rights of access and access charging. We do not see this as being related to the setting of price controls per se and therefore not directly relevant to RPI-X@20. In any event, we are unsure how Ofgem's concerns would actually arise given that it has a requirement to approve both use of system and connection charging methodologies.

Innovation

We welcomed the introduction of the Innovation Funding Incentive (IFI) and believe it has been a demonstrable success. We support the additional stimulus to innovation in DPCR5 through the Low Carbon Network Fund, and would welcome the extension into other sectors.

In conclusion, we support much of the direction of the Emerging Thinking conclusions. Richer business plans, greater engagement with customers and more focus on output measures are all positive steps, provided they are implemented proportionately. However, these positive reforms risk being undermined by Ofgem's suggested way forward on financeability and appeals, which will cut across incentives to invest and, in the case of appeals, make the price control process unworkable.

I hope that you have found our comments above both interesting and useful. If you would like to discuss any of our issues raised then please call.

Yours sincerely

Rob McDonald
Director of Regulation