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7th June 2010

Dear Hannah,

RPI-X@20 current thinking working paper: The length of the price control period

Thank you for the opportunity to provide further views on your current thinking regarding the length of the price control period. I can confirm that our response is not confidential and can be placed on Ofgem's website.

In our response to the RPI-X@20 emerging thinking consultation we favoured retention of a five year review period in conjunction with longer term business plans and outcomes. This remains our position.

In principle, we can see benefits in having longer term price controls as this provides greater certainty for investors and may better facilitate efficient, long term asset management decisions. However, we do not believe the extension of the price control period to eight years, with an interim review, will deliver any significant change in company and/or investor behaviour compared to a five year review period. Moreover, we do not believe the extension of the period to be an appropriate move at a time when the environment facing distribution network operators is likely to be subject to rapid change, both in terms of technology and customer behaviour in response to the low carbon agenda. This level of uncertainty makes longer term forecasting risky, particularly in respect of anticipating what services the network will be required to deliver and how they should be delivered.

Ofgem also recognises that outputs may need to change given that a key element of the strawman is an interim outputs review. However, it is unclear how Ofgem will assess the appropriateness of the outputs, and the associated revenues, without undertaking a full review. In any case, Ofgem's approach would not be small scale. We also do not see how Ofgem could change outputs and revenues without considering how this would impact on the cost of capital.

We are also concerned that the proposals would negate the concept of the price control as a package of proposals. The removal of this important concept will result in significant additional management time being spent on examining and negotiating each element of the price control review, as there may not be the ability to trade off risks across different areas. As a consequence, future reviews are likely to be even more resource intensive for

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both Ofgem and the companies, rather than less so as Ofgem envisages under its proposals. We are also unclear as to whether the Competition Commission would limit themselves to a partial review even where Ofgem had referred a licensee to them on this basis. In particular, we do not see how the Competition Commission could limit the scope of its work given that it is essential applying a broad public interest test to its review work.

The other core element of Ofgem's proposal is the development of uncertainty mechanisms to address forecasting risk. However one of the greatest risks that a licensee would face is the political risk arising from two possible changes of government in a ten year period and the associated (also possible) change to Ofgem's priorities. It is unlikely that this risk could be mitigated and hence investors will require a higher cost of capital.

We have included more detailed comments on the issues raised in the working paper in the attached appendix. If you have any questions on the points raised in this response please do not hesitate to contact me.

We hope that you find this submission helpful.

Yours sincerely,

Paul Delamare
DPCR5 Programme Director

Appendix 1: Detailed comments on longer term price controls strawman

Introduction of a small scale review

Ofgem's current strawman proposes to introduce longer term price controls (e.g. eight to ten years) with an interim small scale review to confirm whether the outputs remain appropriate. The anticipated benefits of this approach are:

- Give network companies a greater financial stake in their performance in planning network investment and anticipating customer needs beyond the five-year horizon.
- Allow network companies to keep more of the rewards from innovation that reduces their expenditure requirements beyond the five-year horizon.
- Reduce the scope for distortions in company behaviour as they approach the end of price control periods.
- Reduce the proportion of time that companies' management teams are involved in comprehensive price control reviews.

We do not believe the strawman proposal will deliver these benefits. The principal reason for this is the introduction of a small scale review. The price control outputs, customer's willingness to pay and hence associated expenditure plans, for the next price controls will have been determined after extensive consultation, at a regional level, with the companies' stakeholders. If outputs are going to be properly reviewed then this process will have to be repeated. This is a key element of the price control process and hence we cannot see how any review would be"small scale". Therefore, we would expect any review of outputs to have a significant impact on management time.

We believe that there is a strong risk that the strawman proposal will be viewed as providing a financial commitment (on cost allowances) only until the small scale review. If the review is held after four rather than five years companies will actually have a shorter commitment than currently exists.   In addition, given that the required outputs are a fundamental component of the price control package if companies' behaviour becomes distorted as they approach the end of a review period we cannot see why this would not also be the case for the small scale review.   We also cannot see how Ofgem can alter outputs and associated revenues without considering the impact that this would have on the cost of capital. For example, if the required outputs and associated revenues were increased substantially, then we expect both the delivery and financeability risk to also increase. This would increase the cost of capital.

In our opinion, the only way such a review would be small scale is if Ofgem unilaterally decided how outputs would be altered.   Consequently, our concern is that the small scale review would be seen as a review of profitability rather than a review of the appropriateness of the outputs. Ofgem acknowledges that a key risk in longer term price controls is that actual and predicted costs diverge resulting in either windfall gains or losses. If Ofgem assesses whether the outputs remain appropriate it could appear that the small scale review is being used to protect customers from excess profits but shareholders would still be required to bear windfall losses Such an asymmetric approach would be wholly inappropriate and would increase regulatory risk and hence the cost of capital.

Another disadvantage of the small scale review is it negates the concept of the price control as a "package". Companies would no longer be able to consider their overall performance from the price control package given that the required outputs and associated revenues may be subject to change. The flexibility that this approach delivered will be lost and we can foresee significant additional time, both Ofgem's and the companies, being expended on negotiating, in detail, each element of the package.

Use of uncertainty mechanisms in a longer term price control

As Ofgem correctly recognise any move to a longer price control will increase uncertainty and hence risk. The straw man proposes to address this uncertainty via:

- The introduction of a small scale review;
- An enhanced role for uncertainty mechanisms; and
- Calibration of upfront efficiency incentives

We have highlighted our concerns with the small scale review above. With respect to uncertainty mechanisms we agree that these can be used to mitigate future uncertainty. However, one of the key areas of uncertainty in a longer term price control would be political uncertainty. It is entirely possible than there could be two changes of government within an eight year price control period. In our view there would be significant practical difficulties in developing uncertainty mechanisms to mitigate this risk and as a consequence the cost of capital would need to increase substantially to compensate investors.

We note that Ofgem have suggested introducing mechanisms were updated cost assessments are undertaken if a trigger event or threshold is exceeded. In theory we can see how these mechanisms could be used to manage the cost risk for both shareholders and customers. However, the fact that such an approach would be limited to specific areas may not reduce the perception of cost risk for investors and hence we would again expect the cost of capital to increase.

Under the proposed strawman we would envisage an increase in the number and complexity of the uncertainty mechanisms. A feature of these mechanisms is that they are not activated until a materiality threshold is triggered. A concern is that as the number of mechanisms grows the aggregate amount of additional cost a company bears, before a mechanism is triggered, could increase. It would therefore seem sensible to have a mechanism which triggers when the aggregate cost across all uncertainty schemes exceeds a defined threshold.

We can see the benefit in exposing the DNOs to the results of the incentives and uncertainty mechanisms as soon as practicable, as this will sharpen incentives. For the majority of incentive mechanisms in DPCR5 this is currently the case. The exception is the Information Quality Incentive which is trued up at the end of each control. However, this proposal would be a significant shift in the treatment of uncertainty mechanisms compared to DPCR5 where mechanisms can only be triggered in two defined windows. As Ofgem note this may result in price volatility for suppliers which will need to be appropriately managed and communicated.

We agree that the use of calibration of efficiency incentives needs to be carefully considered. As Ofgem's example demonstrates in order to keep the cost risk similar across five and eight year control periods the incentive rate in the eight year period would have to reduce by approximately 38% compared to the five year period. This is a significant weakening of the incentive which may result in higher costs for customers in the long term.