

Hannah Nixon
Partner
Transmission and Regulatory Review
Ofgem
9 Millbank
London
SW1P 3GE

6th Floor, Dean Bradley House
52 Horseferry Road, London SW1P 2AF
+ 44 (0)20 7706 5100
www.energynetworks.org

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Dear Hannah

Ofgem's working paper on the length of the price control period

At our meeting on June 7th, we said that we would put in a short response to the above working paper.

In the working paper, Ofgem puts forward a straw man for how a longer-term price control might work. Features of this straw man include an eight-year price control but with a 'potential small-scale review' at four years.

To start with, there is one especially problematic procedural aspect of the proposed mini review. In the event that the review decided that no licence changes were required in the face of what companies considered to be relevant material changes—for example, changes in what outputs companies are required to deliver—there would be no right of appeal to the Competition Commission and the safety-net aspects of the mini review would prove chimerical.

However, the main problem in assessing Ofgem's straw man is that it does not contain enough relevant information to form a view as to whether a longer-term control would indeed make more sense for consumers or for investors. As Ofgem itself recognises a longer-term control would have to deal with increased uncertainty about what networks will need to do over the period and the cost of doing it. Ofgem suggests that it could deal with this increased uncertainty in a number of ways.

- It would take account of changes in what networks need to do at the interim review.
- It would 'calibrate' (probably reduce) the strength of efficiency incentives, albeit that 'It would be important to retain strong efficiency incentives regardless of the length of that [ie, the price control] period'.
- It would develop uncertainty mechanisms, the distinguishing feature of which being that 'they would allow price controls to be adjusted following updated cost assessment carried out by Ofgem during the price control period'.

In other words, depending on:

- what output requirements are set;
- what base cost allowances are made;
- how incentives are calibrated;
- how risk sharing mechanisms work;
- what sort of discretionary cost adjustments would be allowed for during the price control period;
- what adjustments are made to WACC to allow for any change in the risk profile as a result of all the above;

companies could be faced with either a very different risk and incentives profile from the status quo or something very similar.

The proposition that companies would be encouraged purely by an eight-year price control to take a longer-term perspective on developing their networks is not demonstrated by the working paper and is not intuitively plausible. This is, in part, because an eight-year price control is still a rather short period to assess the consequences of major network development decisions and, in part, because—as Ofgem’s own analysis shows—even an eight-year period would require a veritable paraphernalia of adjustment mechanisms and safety nets which would bring into question whether companies were facing an eight-year control in any very meaningful sense.

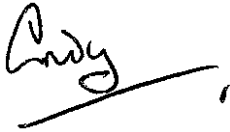
On top of this, Ofgem suggests that a longer-term price control might mean a lower regulatory burden and less regulatory ‘distraction’ for companies than currently exists. We think that this is unlikely to be the case for at least two reasons.

- First, however much effort is put into pre-specifying the ambit of the interim review, it is likely that this will be a major regulatory exercise, with significant opportunities for scope-creep, depending on what unexpected events have occurred and what broader political and economic pressures have arisen during the first part of the control. It is unlikely that any self-denying ordinance set by Ofgem at the start of the control would prevent this.
- Second, as Ofgem itself seems to acknowledge in the part of the Annex dealing with uncertainty mechanisms, these mechanisms could either be fully automatic—in which case they would probably be inadequate to deal with unknown unknowns—or they could be discretionary. In this latter case, they could effectively amount to an annual mini review and an altogether more continuous preoccupation with regulation than currently exists.

In sum, what Ofgem's working paper on longer-term price controls points up is why

- at every regulatory review since privatisation, every UK utility regulatory has asked itself, whether there should be longer-term controls; and
- has, in effect, concluded every time that any benefit in terms of better incentives would be nullified (or worse) by the need for automatic and/or discretionary adjustment mechanisms and stretched credibility as to whether the new arrangements would, in the event, be able to work as planned.

Yours sincerely,

A handwritten signature in black ink that reads "Andy". The signature is written in a cursive style and is underlined with a single horizontal stroke.

Andy Phelps

Director of Regulation

Tel: 020 7706 5118

E-Mail: andy.phelps@energynetworks.org