RPI-X@20 Recommendations

Executive Summary

We have been supporters of the RPI-X @ 20 project since its inception and welcome many of the individual propositions in Ofgem's proposals as representing the sensible evolution of good practice. In particular, we broadly agree with Ofgem's recommendations on objectives, industry structure, enhanced engagement, outputs, ex ante based price controls, the retention of RPI as an index and innovation

The overall acceptability of a price control developed under an RPI-X @ 20 framework to customers, stakeholders and network operators however will depend on the combined effect of the total package of proposals.

In our view Ofgem has failed to properly consider how all the elements interact and we contend that the collective set of principles as presented results in an unacceptable overall price review package.

Our response therefore focuses on those areas where we believe modification is required to the proposals to enable them to interact within a coherent overall RPI-X @ 20 regulatory framework, with a prime focus on financeability where we find the greatest issues with Ofgem's proposals.

We compete for capital in global financial markets and there is currently a myriad of investment opportunities across diverse geographies and industries. In recent years, capital has become an even scarcer resource, and we expect competition for large capital investment to intensify further over the coming decade and beyond. As economies undergo a transition to lower carbon energy systems, we should not be putting the UK's need for £32bn of investment in energy networks at risk of either being unfinanceable or unnecessarily costly for customers. The cost of capital is inherently set by the assessment of regulatory risk. There are a number of interactions, combinations and contrasts within the Ofgem recommendations that, we consider will damage Ofgem's credibility and will, therefore, increase the cost of capital for our customers, such as:

- The call for investors to manage all the cash-flow issues over the "short-term", just as Ofgem are seeking to reset the minimum definition of "short-term" from 5 years to 8 years;
- The introduction of mid-period reviews, introducing a perceived risk of asymmetrical treatment of windfall gains and losses;
- The deliberate creation of cash-flow issues by changing a long-standing treatment of depreciation lives coupled with the call for investors to manage all the cash-flow issues, which adversely impacts on the ability to satisfy investors need for yield;
- The eventual recognition of PMICR as a key ratio, just when the only solution to ratio problems is equity injection - which does not efficiently address PMICR problems;
- The call for investors to trust future unknown incumbents in Ofgem to deliver their necessary returns at a time where there is an obviously increasing politicisation of the regulator's duties and an erosion of regulatory independence;
- An opportunistic switch to debt indexation using long-term trailing averages, which would appear to be a near term reaction to the current macroeconomic

environment, as opposed to the commitment to a long term, unbiased view of the principal drivers of return; and
- Requiring Fast Track companies to commit to price control proposals some eighteen months prior to the commencement of the price control period, effectively exposing those companies to almost ten years of operational risk.

There is a high risk that our sector will be assessed differently by investors if these proposals are implemented unchanged without sensible transition arrangements and a recognition that Ofgem and companies must work together to address financeability issues if they arise at a price control reset.

We have argued throughout the RPI–X @ 20 project that the financeability principles fail to reflect the issues facing equity investors. By adopting these principles, Ofgem will be placing much of the necessary future investment at risk. Equity investors will be unwilling to provide finance on this basis at the prices customers have enjoyed under the RPI-X regime to date. As a consequence, customers will pay an unnecessary premium for the services delivered by network companies.

In terms of other areas where we feel the proposals fall short:

Ofgem's proposals for third party modification requests do not go far enough. We support the consumer right of challenge and recommend that the only party able to challenge a price control should be a statutorily constituted consumer representative body. We believe that, as the ultimate arbiter of best practice in utility regulation the Competition Commission should be more involved in the price control process more regularly and should also undertake the role of gatekeeper to allow a specialist regulatory challenge and ensure an independent public interest test;

We strongly believe that retaining the five year control optimises the balance between regulatory risk, operational risk and incentive mechanisms. Additionally, the mid period review will introduce further risk of asymmetrical treatment of windfall gains and losses and will effectively lead to the introduction of four year price controls. We do not understand why, despite significant opposition from network companies and suppliers on the extension of the price control period, Ofgem has retained its position.

We are concerned that Ofgem's current proposals on proportionate assessment represent a significant departure from established regulatory principles and fall some way short of suggesting workable regulatory processes. In particular, we are concerned that:
- Ofgem has not demonstrated an objective basis for determining which companies should be selected for Fast Track price controls; and
- The Fast Track process would provide no advantage to Fast Track companies. Indeed it will actually increase the levels of risk to which these companies are exposed (both the risk of sub-optimal price controls as well as increased risks associated with agreeing a package that will run for ten years).

With regard to incentives, Ofgem must also ensure that in designing and calibrating incentive schemes they include a long term incentive component. A key shortcoming of the DPCR5 RORE analysis was that it focussed on short term measures rather than long term value.

The decision to abolish the five year outperformance retention period is inappropriate at a time when Ofgem is seeking to maximise efficiency. We do not believe that this decision reflects the need for efficiency but reflects the desire to instantly capture gains. The five year rolling efficiency mechanism provides companies with an incentive to seek out long term efficiencies and its removal may result in a reduced efficiency drive. Abolishing the outperformance retention period would also result in an increasingly fluctuating revenue profile.

We support Ofgem's initial view that RPI remains the most appropriate index. RPI has the benefit of transparency, maintaining appropriate linkages to the ability to pay, mirroring cost of debt movements and maintaining investor confidence. We do not accept that CPI is an appropriate index as it does not represent actual inflation in the UK. RPI is the only appropriate index for compensating investors for financial capital maintenance. We therefore disagree with Ofgem's view that this position should be reviewed.

The proposed principles could be adapted to create a more coherent whole without losing much of the good work undertaken during the RPI-X @ 20 project. In this response we propose changes to the principles on:

- Third party modification requests;
- Length of the price control;
- Proportionate assessment;
- Incentives; and
- Principles for ensuring efficient delivery is financeable.

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Objective:

The overriding objective of energy network regulation is to encourage energy network companies to:

- Play a full role in the delivery of a sustainable energy sector; and
- Deliver long-term value for money network services for existing and future consumers.

Our position to date

Electricity North West has supported the RPI – X @ 20 project as we recognise that there is a need for the regulatory framework to support the next phase of network infrastructure investment. In our earlier responses, we endorsed the need for the review and agreed that the focus of energy network regulation must shift from achieving operating efficiency gains towards facilitating the low carbon economy. The identified objectives have been widely discussed throughout the review and we fully support them.

Impact of the Recommendation

Whilst we welcome the objectives of future energy network regulation, some of the tools and methodologies proposed to deliver them are inappropriate. We believe that this may have resulted from the absence of a clear objective of energy network regulation to ensure that network operators can finance their efficient operations. Given that Ofgem has a statutory responsibility to allow companies to finance their functions, we are surprised that Ofgem has failed to more explicitly reflect the requirements obliged by these duties in the future regulatory framework.

One of the successes of the RPI – X regime is that investors have had confidence in the regulatory framework to enable long term investment. The behaviours and objectives targeted in RIIO could be derailed as a result of the treatment of equity investors. We will discuss our specific concerns in greater detail for each of the recommendations.

Our proposals for a sustainable resolution

We recommend that a further overriding objective of network regulation be included to recognise the importance of ensuring that network operators who efficiently play their role in developing and delivering long term value be able to finance their functions. Delivery against this objective would require that:

- It is possible for network operators to secure comparatively low cost finance over the long-term; and
- The level of risk placed on the business (and the RAV) by the regulatory framework is appropriate, ensuring access to the most efficient long term financing.

Industry structure:

The framework would be implemented under the current industry structure. The Authority would keep under review the need to revisit the alignment of transmission and system operator incentives in gas and electricity, any formal electricity distribution system operator role, and other issues.

Our position to date

The current combination of regulated and competitive markets has delivered substantial improvements since privatisation and we see no reason to move to a different structure at this time.

Impact of the Recommendation

Moving to a different industry structure would increase uncertainty and risk whilst delaying the investment and innovation required for the future networks. Retaining the current industry structure allows the objectives of RIIO to be delivered in a timely manner.

Our proposals for a sustainable resolution

No changes are required to this principle.

Enhanced engagement:

Stakeholders are given greater opportunity to influence Ofgem and network company decision making through enhanced engagement.

Our position to date

We have welcomed enhanced engagement in previous consultation responses. We recognise the need to demonstrate transparency, and that customers must be able to engage with companies to ensure investments are efficient, timely and relevant. Ofgem's intention to build on the DPCR5 stakeholder engagement process with a formalised approach is a welcome addition to the future regulatory framework. Our experience in the DPCR5 process has led us to conclude that:

- Stakeholder engagement provides wider benefits to network companies. Our recent work on demand side management and the Low Carbon Network Fund has been built upon the DPCR5 stakeholder engagement platform;
- Stakeholder views can identify relative priorities for non-core investments (eg flooding, worst served customers, high impact low probability events);
- Stakeholders are happy to defer to the companies' experience for the requirements of the network; and
- Stakeholders do not agree with each other.

The role of the DNO will be to balance the needs of the customers across the network. Ofgem must recognise that regionally-supported efficient business plans should be rewarded with a less intrusive challenge. Ofgem must also be able to demonstrate how they assess the level of engagement within the company business plans. This would require improvements relative to the DPCR5 process where Ofgem was unable to demonstrate how good stakeholder engagement was rewarded within the final proposals.

Impact of the Recommendation

We believe that enhanced engagement is the best way to deliver for customers. We are concerned that the extension of the price control to eight years alongside a limited scope of the mid-point review is at odds with the proposal of encouraging network operators to engage in ongoing debate with their stakeholders. There is a risk that the creation of longer price controls may result in stakeholders becoming frustrated that investment that they fully support cannot be included within outputs for many years. It will be important to ensure that the scope of mid point reviews is able to accommodate changing stakeholder requirements.

Our proposals for a sustainable resolution

No changes are required to this principle.

Third party modification requests:

Ofgem sets out public guidelines on how the Authority would respond to a request from a third party that the Authority exercise its discretionary power and refer a modification to the Competition Commission on the basis that our price control determination may operate against the public interest. Ofgem will keep under review the guidance, including considering the merits of asking government to introduce a formal right of appeal through primary legislation. Ofgem will adapt to, and take account of, any changes that might arise if government consider legislative change in this area, for example in the context of consultation on and implementation of the EU third package.

Our position to date

In our "Emerging Thinking" response, we argued that Ofgem's proposals did not go far enough. We continue to support the introduction of a consumer right of challenge as part of Sustainable Network Regulation.

Impact of the Recommendation

The future framework should include a consumer right of challenge where a case can be made that a decision made by Ofgem is not in the public interest. We believe that the implementation of a third party challenge into a price control will improve regulatory consistency, legitimacy and remove any concerns relating to regulatory capture.

Whilst we support the principle of introducing a third party right of challenge, there is an important balance to be achieved between the benefits of allowing scrutiny of key decisions and the potential to increase the risk associated with delayed and changed price control negotiations. We fear that the process currently described could result in a significant number of inappropriate challenges that would delay the implementation of price controls, increase overall risk and delay key investment.

Our proposals for a sustainable resolution

The introduction of a small number of modifications to Ofgem's proposals will ensure that appropriate and relevant challenges are considered whilst avoiding challenges that are not in the public interest and providing appropriate certainty to other areas of the price control. We outline our proposals below:

Who is best placed to consider the appropriateness of the challenge?

We disagree with Ofgem's retention of the role of gatekeeper. This is an opportunity to utilise the Competition Commission's external view of best regulatory practice and an independent view of the public interest. If an Ofgem decision is challenged, as would be expected from time to time, then it is very much in customers' interests to ensure that a truly independent body has reviewed the challenge and provided a rational conclusion on its ruling, whatever the outcome.

The Competition Commission should review the specific areas of public interest challenge and decide if the case warrants a review. The Competition Commission should be mindful of the impact on the financeability of the proposed package.

Who can challenge a price control decision?

The only party able to challenge a price control should be a statutorily constituted consumer representative body. This body would need to consider the interests of current and future customers as well as the public interest in making any challenge.

What should the scope of an acceptable challenge include?

Third party challenges should be made against specific elements of the control which are expected to operate against the public interest of current and future customers. This position must be evidenced based. This will allow the Competition Commission to understand the reasons for the challenge and the impact on the holistic price control package.

A process should be introduced to allow third parties to challenge the limited changes introduced at mid point reviews. The scope of reviews at this stage in the price control must be very carefully controlled in order to avoid the perceived risk that full price controls could be reviewed by the Competition Commission after just four years.

What process should the challenge follow?

Ofgem's proposed timescales appear broadly appropriate but in order to minimise risk, third parties should not be allowed to appeal after the statutory consultation period. Ofgem must ensure that the proposed six week deliberation period is included in the price control timetables to ensure that decisions are made in a timely manner and investment programmes are not inappropriately delayed.

A challenge window should be included within the price control timetable so that no material increases in uncertainty would occur.

Stakeholders should bear their own costs and the costs of the Competition Commission's initial assessment up to the point of appeal. If the Competition Commission accepts the challenge as being legitimate, then the public interest need has been established and the ongoing costs should be socialised.

We recognise that this position would require a change in primary legislation. Whilst this may add to the complexity to the implementation of the RIIO recommendations, it will increase the effectiveness of the right of challenge process.

Outputs-led:

The price control would set outputs that network companies are expected to deliver to ensure safe and reliable services, non-discriminatory and timely connection and access terms, customer satisfaction, limited impact on the environment and delivery of social obligations.

Our position to date

The principle of including outputs in price controls was welcomed by Electricity North West in DPCR5 and in RIIO. The company's development of health indices during DPCR4 to demonstrate the network health and subsequent investment requirements provides a new level of transparency and accountability for customers.

Impact of the Recommendation

We welcome the adoption of outcomes and outputs in the future regulatory framework. Utilising outputs to deliver the identified outcomes will provide a mechanism to monitor delivery of solutions and provide a transparent mechanism to demonstrate value for money. The linkage between outcomes and outputs will not always be clear however, and care will be required to manage tension between different outputs to ensure network companies deliver a compatible suite of complementary outputs. Great care will also be needed in specifying outcomes and outputs to ensure that the definitions do not preclude innovation in delivery; there is a risk that focussing on delivery of specific inputs and outputs may discourage more innovative means of delivering required outcomes.

Our only concern on the adoption of outputs relates to the role of DNO-specific measures. The "Emerging Thinking" paper suggested that price controls would increasingly become a set of bilaterally-agreed arrangements based on regionally-specific, stakeholder-endorsed plans. We believe that this is important and that the emphasis should be placed on measures specific to each plan that could be used to monitor delivery objectively. This would accord at least equivalent status to those measures classed as 'secondary' in the outputs framework. Although these are not currently directly comparable across network operators, they are far more important determinants of future network risk and costs than the short-term, more observable 'primary' measures discussed.

We note that Ofgem has retained the safety output category. We understand Ofgem's view that customers must understand what a company will deliver for its allowed revenue. We still believe that its inclusion represents inappropriate signals that managing network risk across outputs could involve trade-offs of safety against other output categories and note that the Frontier Economics paper on outputs could not identify any meaningful metrics in this area.

Our proposals for a sustainable resolution

No changes are required to this principle.

Retaining an ex ante control:

We would continue to set an upfront price control, incorporating a return on the regulatory asset value and inflation indexation. We think that it is appropriate to retain the retail prices index as the inflation index but will test our thinking over the summer before finalising our view.

Our position to date

Electricity North West fully supports the recommendation to set ex-ante price controls. We have advocated adapting the existing methodology to capture some of the benefits of an ex-post control (eg encouraging investment) whilst minimising any uncertainty for investors. Any change to an ex-post price control would need to deliver the investment required whilst protecting current and future customers and retaining investor confidence gained throughout previous price controls. We can see no justification for undertaking such a risky change in the nature of regulation.

In our previous responses, we have noted the importance of an appropriate inflation adjustment index in the price control settlement. It is appropriate to retain the principle of financial capital maintenance in future price controls. Real returns must be maintained through the appropriate indexation of the RAV and its subsequent returns. Maintaining investors' real returns requires the use a measure reflective of the real movement in wealth of an investor through some measure of inflation indexation. Ofgem used the RPI at privatisation to provide a link to:

- Customers ability to pay;
- Company cost movements; and
- Maintaining real returns to investors.

The link to RPI must be maintained to provide appropriate financial capital maintenance for investors.

Impact of the Recommendation

The recommendation to retain an ex ante price control and the RPI as indexation will maintain investor confidence in the regulatory framework. Moving to either an ex-post price control or CPI based index would increase the risk perception of the sector resulting in a higher cost of capital requirement. We do not believe that either of these options would represent the best interests of customers.

The proposed retention of the RPI in the price control as the inflation index is welcomed. We do not accept that CPI could ever be an appropriate index to provide financial capital maintenance as it does not represent actual inflation in the UK (a position recognised by the Office of National Statistics in its paper on the HICP). The RPI has the benefit of transparency, maintaining appropriate linkages to the ability to pay, mirroring cost of debt movements and maintaining investor confidence. Breaking the link with the RPI will result in the erosion of current investors' trust in the regulatory framework and would be viewed as regulatory opportunism.

Ofgem's position that the price control package should be calibrated against the other elements of the price control to reflect the "faster growing" index fails to recognise the true impact of the decision to retain RPI. Moving to a CPI based

control which does not reflect the actual UK inflation rate will increase the risk profile of the companies and would require compensation via a higher WACC.

The DPCR5 discussions around the suitability of RPI for indexing revenues highlighted that there were variations between the movements in costs and the allowed growth term requiring an adjustment for Real Price Effects (RPE). Any movement away from RPI to CPI would additionally increase the magnitude of this issue.

Our proposals for a sustainable resolution

No changes are required to this principle.

Length of the price control:

The price control would be set for eight years, with provision for a mid period review of the outputs that network companies are required to deliver. Uncertainty mechanisms would be implemented consistent with transparent RPI-X @ 20 principles on the use of such mechanisms. There would be scope to review the length of the control period at future price control reviews.

Our position to date

We have argued in previous submissions that a move to eight year price controls is inappropriate as the extension of the price control duration will substitute regulatory risk for operational risk. We strongly believe that retaining the five year control optimises the balance between regulatory risk, operational risk and incentive mechanisms. Additionally, the mid period review will introduce further risk of asymmetrical treatment of windfall gains and losses and will effectively lead to the introduction of four year price controls. We do not understand why, despite significant opposition from network companies and suppliers on the extension of the price control period, Ofgem has retained its position.

Impact of the Recommendation

Network operators are facing the greatest level of uncertainty in their history. Factors such as the low carbon future, consumption volatility due to macro-economic factors, unit cost volatility driven by market turmoil and the availability of finance along with the need for a significant increase in investment and changes to the regulatory structure are increasing the risks for networks and their stakeholders. To ensure that these risks are efficiently priced into a price control, regular resets are required.

The underlying issue with longer-term price controls is that, as with any price control, the environment in which network companies operate changes. In our previous submissions, we noted our position that the introduction of longer term price controls is not in consumers' interests as:

- Longer price controls expose network operators to the increased risk that events will occur that were not foreseen within their price control. They increase operational risk, increase the carry period of logged-up expenditure and increase the impact of error in setting allowances and calculating the WACC. The introduction of midpoint reviews with the terms of reference currently proposed by Ofgem introduces additional risk, which would require compensation via a higher WACC;
- Increasing the length of the price control will not lead to longer term thinking. It is likely to encourage greater risk aversion in investment planning;
- Detuning of incentive mechanisms would reduce investment in improving performance;
- Increased use of uncertainty mechanisms will increase price volatility, increase price control complexity and consequential resource costs and increase risk of unintended consequences; and
- The call for investors to manage all the cash-flow issues over the "short-term", just as Ofgem are seeking to reset the minimum definition of "short-term" from 5 years to 8 years highlights that Ofgem have failed to take an appropriate high level view of the recommendations in the impact assessment.

The proposal to introduce small scale mid-point reviews to allow price controls to be re-opened in certain specific circumstances is well intended but exposes companies to significant additional risk:

- There is a risk that future regulators use the small scale review to claw back any perceived windfall gains but would hide behind the limited stated scope of the small review to avoid equivalent adjustments for financial losses;
- The limited scope of the mid-point review seems at odds with the proposal of encouraging network operators to engage in ongoing debate with their stakeholders;
- Ofgem has not provided details of the proposed approach to introducing licence modifications resulting from the mid point review. It is unclear what processes would be introduced to allow network operators to challenge the decisions made by Ofgem;
- If there is a possibility that third parties could challenge the mid-point review, or a likelihood that the results of the mid point review could be referred to the Competition Commission, the full scope of the price control would end up being reviewed. This would effectively mean that network operators are subject to four-year price controls;
- It is unclear how outputs would be costed at the mid-point review. It is hard to see how it would be efficient to cost the changed outputs at the prices which were anticipated four years previously; and
- There is a risk that the processes described in the document would effectively lead to four year price controls and introduce more work rather than less for both Ofgem and companies. This will result in extra costs being incurred by both network operators and Ofgem.

The cost of all of these factors would need to be borne by consumers, predominantly via an increased cost of capital. We therefore fail to see how this could be the most appropriate outcome for customers.

The fact that Ofgem themselves suggest that price control periods will be reviewed at each review underlines their own uncertainty in the appropriateness of this decision. However, it must be noted that by failing to commit to a set timescale Ofgem are further increasing regulatory risk and exacerbating the price that customers will have to pay for companies to manage these risks.

Our proposals for a sustainable resolution

The following recommendation would be a more appropriate goal for the future regulatory framework:

The price control would be set for five years, with the outputs that companies must deliver fixed for the full five year period. Uncertainty mechanisms would be implemented consistent with transparent RPI-X@20 principles on the use of such mechanisms.

A five year price control provides an appropriate balance of operational and regulatory risk. It also allows timely enhanced stakeholder engagement.

Ofgem should concentrate its activities on introducing uncertainty mechanisms within 5 year price controls that provide appropriate protection to both customers and shareholders for risks outside of the normal course of business. Risks should be

borne by the party best placed to manage the risk. This may involve the introduction of sharing factors and/ or revenue drivers. In some circumstances annual reopener application windows (akin to the water IDoK regime) will be the most appropriate mechanisms as they balance the need to clear application periods whilst maintaining the uncertainty management principles they are seeking to create.

This will ensure that companies are exposed to risks that they can manage and control, allowing them to concentrate on using long term planning and incentives to encourage sustainable regulation rather than responding to uncontrollable events.

Once risks have been appropriately apportioned and uncertainty mechanisms put in place the cost of capital assessment would then need to reflect the level of risk ultimately borne by investors.

Proportionate assessment:

We would adopt a transparent and proportionate approach to assessing the price control package, with the intensity and timescale of assessment reflecting the quality of an individual company's business plan and its record for efficient output delivery. Under this approach, we may conclude the process early for some companies.

Our position to date

Ofgem's assessment of future business plans will need to be substantially different from the approach adopted in previous price controls. Future comparative modelling will need to evolve to take account of variations in company endorsed investment plans.

We continue to support our earlier statements on the subject, specifically:

- We recognise that future business plans will be shaped around regional customers. Each DNO may be asked by its customers to adopt a different risk profile, depending upon their needs and appetite to adopt commercial arrangements;
- We agree that decarbonisation and an ageing network mean that use of networks will change and that therefore historical spend is an increasingly poor indicator of future spend;
- We agree that equalisation of opex and capex means that historical disaggregated approaches will be less relevant in the future; and
- We agree that future schemes need to encourage innovation and agree that ex-post adjustments introduce a perception of regulatory risk that may discourage it.

Impact of the Recommendation

We are concerned that Ofgem's current proposals represent a significant departure from established regulatory principles and fall some way short of suggesting workable regulatory processes.

In particular, we are concerned that:

- Ofgem has not demonstrated an objective basis for determining which companies should be selected for Fast Track price controls; and
- The Fast Track process would provide no advantage to Fast Track companies. Indeed it will actually increase the levels of risk to which these companies are exposed (both the risk of sub-optimal price controls as well as increased risks associated with agreeing a package that will run for ten years).

We would be pleased to work with Ofgem on developing the concept of price controls and suggest some improvements below.

Our proposals for a sustainable resolution

Determining which companies should be subject to fast track price controls.

We are very concerned that Ofgem currently does not have appropriate comparative models available to objectively determine which companies should be subject to Fast Track price controls. Indeed, in the one area where Ofgem has historically undertaken modelling, comparative efficiency, the models developed for DPCR5 fell a long way short of the robust modelling that should be expected when making fundamental decisions about companies' futures. Ofgem does not currently have any models available to objectively compare companies' performance in delivering outputs or engaging with stakeholders. Indeed Frontier Economics have suggested that developing comparative measures for key "secondary" outputs would prove very difficult.

To date, the only proposals that we have seen as to how companies might be compared is contained within Frontier Economics' report on the future role of benchmarking. We raised a number of specific concerns with their proposals in our previous response, including:

- The current proposals only suggest using a subset of outputs as cost drivers and omit some of the most significant drivers of expenditure, particularly outputs to be delivered to maintain medium and long term reliability indicators (secondary outputs). Changes in medium and long term forecast reliability indicators are much more important drivers of future cost than units distributed, losses performance and current CI/ CML performance;
- Some of the drivers suggested by Frontier are not exogenous measures and hence results may be distorted by a DNO's assessment of future activity. Where measures of work to be undertaken are to be used as cost drivers, it will always be necessary to assess the volume of work to be undertaken separately and then assess the efficiency of delivering the required work;
- The simple nature of the proposed model will not allow some of the value adding features desired by other aspects of the Emerging Thinking framework. For example, it is not easy to see how the model could recognise leadership in stakeholder engagement or correctly adjust for levels of innovation. It is also increasingly apparent that the concept of "light touch" regulation for fast tracked DNOs would be impracticable in a context where all DNOs' data points are included within a comparative model; even the better performing DNOs would be subject to detailed data collection requirements to allow the models to be populated; and
- Whilst we agree that total cost models should form a key component of future regulatory benchmarking, measures of total cost are notoriously difficult to achieve without introducing distortions as a consequence of differences in timing of respective investment cycles. It will always be necessary to use a range of models to inform assessing comparative efficiency assessment to avoid undue reliance on one model.

The fact that Ofgem's recommendations fail to address these issues increases our concern that Ofgem is not in a position to accurately and objectively determine which companies deserve Fast Track status.

Ofgem needs to urgently dedicate appropriate resources to developing the objective comparative models that will be required to determine which companies will be subject to fast track price controls. These models must be able to recognise that

value for money includes a quality component which needs to be assessed if it introduces longer term flexibility and therefore efficiency. Electricity North West is willing to assist Ofgem in this very important and technically complex task.

The desired end result should be the publication of an annual report from Ofgem, using annually reported data that indicates the relative performance of all companies. This would assist the process of ensuring that these issues are well understood by all stakeholders prior to the commencement of a price control review and provide all parties with have greater confidence in the assessment techniques, data and results.

Ensuring that Fast Track companies benefit from their status

Ofgem's proposals will increase the risks that Fast Track companies are exposed to. These increased risks result from a number of factors including:

- Exposing Fast Track companies to an extra 18 months of operational and uncertainty risk by requiring them to sign up to price controls many months before the control period commences; and
- Preventing Fast Track companies from benefiting from late changes to policy decisions that often arise within the last months of the price control negotiations.

Additionally, we expect that Fast Track companies will still be exposed to the same level of resource-intensive data requests in order to feed the requirements of comparative modelling to which the remaining companies are exposed.

We conclude, therefore, that Ofgem's proposals would potentially place companies selected for Fast Track at a disadvantage over companies exposed to the more traditional price control processes. This imbalance could be partly redressed by allowing Fast Track companies to ultimately choose between the price control proposed at Fast Track decision and the ultimate price control rules established for the remaining companies. Ofgem should, however, consider whether further rewards are appropriate to recognise the leading role played by Fast Track companies.

Option to give third parties a greater role in delivery:

We would include, in the regulatory tool-kit, the option to require a company to provide market testing evidence that its proposals reflect long-term value for money. We would have the option to involve third parties in delivery and ownership of large and separable projects, where this is expected to drive innovation, long-term value for money and/or more timely delivery.

Our position to date

One of the overriding requirements of the RIIO framework is to facilitate and encourage investment for the low carbon economy in a timely manner. The approach promoted by Ofgem in previous proposals may have resulted in delays to critical infrastructure. The existing obligations set out in the Electricity Distribution Licence to provide a service "at any Entry Point and in any quantity that was specified by the requester" and to "manage and operate the Distribution Business in a way that is calculated to ensure that it does not restrict, prevent, or distort competition in the supply of electricity or gas, the shipping of gas, the generation of electricity, or participation in the operation of an Interconnector" provide a greater level of protection for customers.

Impact of the Recommendation

The recommendations provide a more sensible approach than the position in the "Emerging Thinking" consultation. We worry, however, that Ofgem has false expectations as to the value that can be created by third party involvement in networks' activities. For example, market testing will only identify the cheapest short term solution. Ofgem are asking companies to adopt long term focus and strategies but are proposing to link revenues to spot cost rates. This will only provide short term cost comparability assessments rather than long term value for money judgements.

We also have concerns that the proposals to give third parties a greater role in delivery could lead to a more fragmented network structure which will not be in the public interest. Significant work will be required to develop a set of suitable tests to determine the circumstances under which it is in customers' interest to force third party involvement in delivery of activities. Care would also need to be taken to ensure that the process of allocating work to third parties would not introduce unnecessary delays in the delivery of key infrastructure projects.

Our proposals for a sustainable resolution

The option to require third party delivery should only be exercised when companies are deemed to be inefficient and when long term customer benefit from the approach has been unequivocally proved.

Incentives:

There would be transparent rewards / penalties related to output delivery, including a backstop threat of using our existing powers for enforcement action and potential licence revocation for persistent non-delivery. There would be transparent, upfront, symmetric sharing rules for under-and overspend. Incentives would be calibrated to ensure they provide long-term value for money.

Our position to date

Electricity North West has always advocated the use of appropriate, targeted incentive mechanisms to stimulate behaviours. These mechanisms have been important throughout the last twenty years to stimulate investment, create efficiency and correct inappropriate behaviours resulting from the wider RPI – X framework. The value of these mechanisms is that they provide signals for economically rational companies to respond in a timely manner. The incentive framework has received a number of criticisms in recent years but these have usually been from the design of the mechanism rather than the principle of whether incentives are appropriate (normally in terms of complexity or scale of reward).

Strong long term incentive frameworks are the most effective way to encourage longer term thinking; such approaches are far preferable to extending price control durations with consequential increases in risk. We recognise that one of the issues with providing long term incentives is that the level of complexity of the price controls increases. A complex business environment requires a complex price control framework; this is good for all parties.

Impact of the Recommendation

We welcome Ofgem's decision to publish a strategy document setting out the underlying principles for the price control including WACC, indexation, uncertainty mechanisms and incentive package to allow robust business plans to be submitted. This should provide companies with clarity at the start of a control and enable robust and targeted business plans.

Whilst these commitments are applauded, we are concerned that companies will only be in a position to understand the impacts and linkages across the packages when Ofgem publishes its individual price control strategy documents. Ofgem should additionally develop a set of principles that will apply across price controls to encourage long term behaviours. In developing these principles, Ofgem should take into account that:

- Financial incentives provide the most effective signals to economically rational companies;
- Limiting the use of ex-post incentives is desirable. They represent the least effective financial incentive mechanism; and
- Regulatory discretion over scale and timing of incentives will reduce the behavioural properties of the incentive.

The existence of these long term principles will minimise the perceived risks to investors including guaranteed returns on large infrastructure projects which need to

be built irrespective of the output priorities. Stability of returns encourages long term equity investors to provide investment capital.

Ofgem needs to consider how to incentivise a company of the future. The future needs of the networks may be built around a combination of assets and commercial solutions such as purchasing demand side response. This may require different incentive properties to properly compensate for the additional risk adopted from non-network solutions.

We agree with Ofgem's statement that they will only use financial incentives when there is clarity on the outputs to be delivered, there is confidence in the dataset, delivery is important and there are no other incentives in place. We are concerned, however, that their focus on incentive schemes focussed on primary outputs will result in a short term incentive framework when companies are being encouraged to think on a longer term horizon. Ofgem are failing to recognise that secondary outputs are the most likely drivers of innovation and network preparation. Therefore, incentivising secondary outputs is important to deliver long term value for money.

Ofgem must also ensure that in designing and calibrating incentive schemes they include a long term incentive component. A key shortcoming of the DPCR5 RORE analysis was that it focussed on short term measures rather than long term value.

The decision to abolish the five year outperformance retention period is inappropriate at a time when Ofgem is seeking to maximise efficiency. We do not believe that this decision reflects the need for efficiency but reflects the desire to instantly capture gains. The five year rolling efficiency mechanism provides companies with an incentive to seek out long term efficiencies and its removal may result in a reduced efficiency drive. Abolishing the outperformance retention period would also result in an increasingly fluctuating revenue profile.

Our proposals for a sustainable resolution

Establishing a long term incentive framework is the most effective way to encourage efficient long term business planning rather than increasing the price control duration. In order to introduce effective long term incentive frameworks Ofgem should:

- Establish a long-term ex-ante incentive framework for both primary and secondary outputs and should appropriately reflect the expected dynamics of the next and subsequent control periods;
- Establish an incentive framework for each price control in a comprehensive strategy document; and
- Include a fixed outperformance retention period within the RIIO framework to support the future efficiency delivery.

Principles for ensuring efficient delivery is financeable:

Ofgem will ensure that efficient delivery of outputs is financeable by committing to publish the principles for setting a WACC-based allowed return to reflect the cash flow risk of the business over the long term. Financeability would be assessed in the round, including a cross-check against relevant credit rating ratios. As now, network companies would be expected to manage their business, including capital structure, efficiently to ensure they are financeable.

Our position to date

We have welcomed Ofgem's recognition of the value of long-term principles and agree that they can strengthen regulatory commitment. We have consistently argued that these measures, if implemented correctly, can reduce risks and therefore costs for customers. We do not believe that Ofgem has correctly identified appropriate principles to deliver the future investment requirements. In our responses to Ofgem's and CEPA's papers on financeability we have raised the following points:

- Given the additional risks presented by many of the other proposals, the additional commitment provided by a set of regulatory principles, whilst welcome, is insufficient to generate the strength of commitment required to attract investors at a reasonable cost of capital;
- The recommendations represent a theoretical model which could not be applied to the actual financing requirements of DNOs;
- The proposals are inconsistent with the other proposals in RPI-X @ 20 and the financial ring fence consultation;
- Ofgem need to attract and retain investors rather than just compensate them;
- It is not possible for Ofgem to bind the hands of their successors. During DPCR5 all energy network companies have experienced the review of a set of regulatory principles related to pensions that had been established only three years earlier;
- The straw-man has the potential to create significant short-term cash flow issues for companies with substantial capital expenditure requirements
- Financeability problems can be solved by equity, but this solution is financially inefficient and likely to be expensive for customers;
- Electricity North West's two owners are both open-ended infrastructure funds with a clear requirement for steady long term cash yields to meet their investors' expectations. This requirement is common to all pension fund investors in this asset class;
- The proposed straw-man principles will create unacceptable risk profiles for the long-term utility investors which Ofgem are seeking to attract. The proposed mechanisms recognise the need to move risk away from customers (for example - indexing the cost of debt) but fail to recognise the increased operational risk of longer term controls. The cost of increasing the risk profile of the network company is a significantly higher cost of capital with resulting price increases for both current and future customers;
- The behaviours which Ofgem are likely to encourage with the adoption of a 10 year trailing average cost of debt are not beneficial for customers. If rates climb, which seems likely, it will insulate customers from the costs of such debt for a considerable period. Whilst this appears superficially beneficial to

customers, it calls into question whether Ofgem will have discharged its duty to ensure companies can finance their function, which must be a forward-looking test. In the longer term, faced with a regulatory principle of this nature companies are more likely to move to shorter-term debt financing arrangements to seek to mirror the regulatory arrangements, and thereby avoid penalties. As we have experienced with the recent volatility in price and availability of debt, it is not desirable for companies to be refinancing more than half of its debt portfolio within a single regulatory period; and

- There is a circularity in Ofgem's position on the need for additional equity to deal with revenue volatility. Introducing additional equity requires the strength of incentive mechanisms to be increased in order to retain the incentive properties measured under a RORE approach. It must be recognised that increasing the strength of the incentive mechanisms will exacerbate revenue volatility, for which the Ofgem solution is further equity injection. This issue demonstrates the need for a range of tools to address financeability issues and why Ofgem must seek to balance the whole regulatory framework, not just address individual issues in isolation.

Impact of the Recommendation

Overall

We have significant concerns with several of Ofgem's financeability proposals. A number of the recommendations as currently presented in the paper will significantly discourage future equity investment in the regulated networks. Ofgem's earlier work described its preferred profile for infrastructure investors; we were encouraged by the close match with our own investors' characteristics. Disappointingly, we do not recognise the risk or revenue profiles presented in the most recent recommendations as being consistent with the investment requirements of a utility investor. Pension funds and equivalent investors require stable returns from their investments over the long term, with the provision of consistent low-risk index-linked returns being fundamental to attracting investment into this asset class.

Investors and credit rating agencies have also expressed significant concerns with Ofgem's proposals. Ofgem must ensure that their concerns are reflected in the framework. Moody's noted its concern that the proposals are unlikely to deliver the level of funding required due to the direction of the financeability discussions;

> "More generally, on the point of funding, we highlight the risk that the financial complexity of the network companies could increase as a result of decisions taken by Ofgem in this review. The potentially added complexity may effectively act as a deterrent for future investors into the sector. We believe that many infrastructure funds and general investors have become well-acquainted with the methodology required to undertake a credit assessment of such companies and therefore increased complexity may see some investors prefer to take their money elsewhere, which could have a direct impact on future availability of finance."

We have also noted the comments made by Invesco Perpetual on the recent price controls and regulatory frameworks. The fact that one of the largest infrastructure investors is commenting that they have to

> "shoulder an increasingly anti-equity culture at Ofgem" with objectives "predicated on the impossible more investment with lower prices".

Invesco Perpetual concluded by stating that

> "utility returns must compete with those available in other industries… if regulators and the Government fail to recognise this, then the vital infrastructure investment this economy needs will not be built".

Ofgem should also note that this point was mirrored to the CC in the Bristol Water review.

The key reason for the RPI – X @ 20 review was to ensure that the regulatory framework would support the transition to a low carbon economy. As Ofgem's financeability recommendations stand, they will not encourage investors to provide a sufficient level of investment at an efficient rate. Moody's raised this issue in its commentary on the "Emerging Thinking" paper:

> "We applaud Ofgem's stated desire to retain a framework that is transparent and accessible but question how far that accessibility can be taken due to the inherent complexities of the industry and its financing. Any significant changes in the way that the components of financeability are treated could lead to some investors no longer providing finance, increasing overall financing risk".

Specific Principles

We discuss our views of each of Ofgem's identified principles for financeability below:

A longer-term view of financeability - reinforced by regulatory commitment;

We have noted in our previous responses that Ofgem cannot provide the level of regulatory commitment needed to balance the additional risks created by its proposals. In a report by Moody's (and highlighted by Ofgem in its recommendations), they note that Ofgem effectively has a "licence to print RAV" which could be misused if the regulator were to defer the recovery of costs and investments and thereby shifts costs onto future customers (with the increased risk that such customers may be unwilling to pay). This scenario has not occurred to date supporting investors' perception of a high degree of independence of Ofgem from any political bias to limit price increases for customers". We hold the same concerns that Ofgem are politicising the RAV which will increase regulatory risk and increase the cost to customers.

Risks to be appropriately allocated between companies and consumers - depending on who is the best placed to manage them;

We agree that this is a sensible principle. It is important that the cost of capital reflects the risk profile of the companies under the new framework.

A principles-based approach to the calculation of notional gearing, with the size of the notional equity wedge reflecting the company's risk exposure and potentially varying within and between sectors;

We note CEPA's paper on the proposed equity wedge principles. The ENA (via OXERA) will provide a more substantive response on these principles but we challenge the following points:

- CEPA has suggested that equity must directly replace debt to increase the equity wedge. We have previously commented on this issue noting that directly replacing debt with equity is very expensive and inefficient;
- The model suggests that the starting point should be 100% debt funded. We suggest that the starting point should be at the most cost efficient level of gearing in terms of finance. We do not believe that this rate is at 100% gearing as at these levels, debt is priced and behaves like equity. It is likely that the optimal level mirrors the credit rating agency view as that level provides debt at the most efficient rate;
- The paper suggests that individual companies will be given differing rates of gearing dependent upon their individual risk profile. This must be translated into the WACC; and
- CEPA suggest that Welsh Water was 100% debt funded when it was purchased by Glas Cymru. This is incorrect as the company was purchased at an 8% discount to RCV and received revenues based upon a 57.5% gearing assumption which jointly created an equity wedge.

A real, weighted average cost of capital (WACC) based approach to setting allowed return;

As we have noted in our earlier comments, the WACC must reflect the equity wedge. Given the need to increase investment in the networks, Ofgem must set a WACC to attract investors rather than simply retain the existing providers.

The cost of debt assumed in the WACC to be based on a long-term trailing average and updated annually within a price control;

Ofgem's proposal to introduce a long-term trailing average cost of debt encourages inappropriate behaviours, represents regulatory opportunism and prevents Ofgem from discharging its financing duty. Ofgem's position that efficient debt secured at above the current return would be fully funded in the future fails to recognise that companies would be penalised initially; this cannot be consistent with its duty to finance efficient businesses.

CAPM, supported by other approaches, to be used to determine the cost of equity;

We agree with this principle. The cost of equity should reflect the risk exposure of the network for duration of the price control. In the recent Bristol Water determination, the CC noted

> "It is sometimes suggested that regulators should seek explicitly to set required return equal to some concept of long-term average cost of capital rather than the expected cost of capital for the specific price cap period. It seems to us that this would not be consistent with our duties in this reference. Setting required return below the expected cost of capital for the period would not be consistent with the section 2(2A)(c) duty to secure that the company can finance the proper carrying out of its functions."

We agree with the CC's position.

A capitalisation policy that equalises incentives but is also based on companies' business plans and so is closely aligned with actual opex/capex split;

We have strongly supported the equalisation of incentives. We believe that capitalisation of expenditure into the RAV is an appropriate tool to aid financeability.

We do not believe that aligning RAV additions with company plans is appropriate. Companies should be incentivised to deliver the lowest whole of life cost investment; their proposals may be distorted from lowest cost solutions by any anticipated differential treatment of alternative solutions.

Assumed asset lives underpinning the depreciation policy to reflect expected economic life, with potential to weight the depreciation profile to reflect uncertainty in the future consumption of assets;

We do not believe that this principle will deliver long term benefits for customers. We have noted the difficulty in assigning economic asset lives to assets given the nature of the existing and potential future asset base. There is the potential to create uncertainty by shifting the asset lives over differing controls for political purposes.

We have previously discussed the practical difficulties in establishing a robust, time-consistent economic life for network assets. We disagree with Ofgem's assertion that future customers may benefit more from the investment than current customers. The nature and composition of the future assets will change as the move to low carbon smart networks develops. Indeed, the move to a green economy means that it has never been less certain what types of assets future customers will use. As a consequence, the economic lives of assets are likely to be materially shorter than engineering lives.

It is important that any decision on the future depreciation profile considers the impact on the ongoing financeability requirements of a sustainable network. Depreciation is one of the potential levers to efficiently address financeability concerns. Decisions to take a different approach in this area will require adjustments in other areas to ensure that Ofgem meet its obligations. If Ofgem decides to use longer asset lives as part of its future controls, appropriate transitional periods must be included to ensure that the regulators change in policy does not create additional financeability constraints.

Financeability assessment to be informed by a number of sources including ratings agency credit metrics considered over the long-term;

The cross-check against credit rating agencies is a welcome addition to Ofgem's Emerging Thinking position. Credit rating agencies carry out a number of tests which are relied upon by investors and allow networks to access finance at the most efficient rates. We are also pleased that Ofgem has recognised the importance of the PMICR in financeability assessments.

An onus on companies to manage short-term requirements and to provide equity where necessary

The key to this issue is Ofgem's definition of short term requirements. A short term time horizon could be two to three years or could be within a price control. Ofgem's decision to extend the price control to eight years may have implications for the definition of short term. Investors are happy to provide equity to fund asset growth but it is a different issue to ask them to provide finance as a result of a political desire to profile revenues. Using a smooth profile is likely to create additional financeability constraints on companies for very little benefit. Ofgem should commit to a principle that revenues should match investment profiles in order to avoid creating additional financeability problems.

Return on regulated equity (RORE) analysis used to check the package fits together appropriately.

The RORE mechanism provides a framework to discuss the appropriate balance of incentive packages. As we have already noted in our earlier points, the framework uses short term incentives which are inappropriate given the long term focus of RIIO. The design of the future incentive framework appears to be based on delivery of primary outputs which are shorter term focused than fundamentally important "secondary" measures.

Our proposals for a sustainable resolution

The following principle would be more appropriate for the recommendations:

"Ofgem will ensure that efficient delivery of outputs is financeable by committing to publish the principles for setting a stable and sustainable WACC-based allowed return over the long term and working with licensees to manage the cash flow risk of the business over the short term. Financeability would be assessed in the round, including a cross-check against relevant credit rating ratios. As now, network companies would be expected to manage their business, including capital structure, efficiently to ensure they are financeable and Ofgem will set price controls that demonstrate their duty to ensure efficient businesses are financeable."

A very significant number of changes are required to make Ofgem's financeability proposals in order to ensure the ongoing availability of sufficient investment to ensure that the future investment needs of our energy networks are met.

Innovation stimulus package:

Ofgem will introduce a time-limited innovation stimulus for electricity and gas networks. These would be open to projects at any point in the innovation cycle and to both network companies and third parties for innovation related to delivering the networks required for a low carbon energy sector. The innovation stimulus package would include substantial prize funds to reward network companies and third parties that successfully implement new commercial and charging arrangements to help deliver a sustainable energy sector.

Our position to date

Ofgem's introduction of further specific innovation stimulus in DPCR5 is recognised as a positive step towards the development of the future network company. Many of the benefits that will result from these funds will be transferable across regional and sectoral boundaries. We believe that opening up the new funding arrangements to other network and non network companies will encourage the type of innovative thinking that the Low Carbon Network Fund is seeking to deliver. We recommend that network operators need to be part of any consortium to ensure that there is a real need for any proposed network solution.

Impact of the Recommendation

We agree that Ofgem's proposals will help to encourage innovative network solutions.

Our proposals for a sustainable resolution

No changes are required to this principle.