



SP Transmission, SP Distribution and SP Manweb (SPEN)

**Regulating Energy Networks for the Future
RPI-X@20 Recommendations**

6th September 2010

SP Energy Networks' Response to Ofgem's RPI-X@ 20 – Recommendations

1 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.

We welcome the recognition of the need for energy network operators to play a full role in the delivery of a sustainable energy sector to facilitate the transition to a low a carbon economy. This provides unprecedented challenges and opportunities for the energy sector and will require significant increases in investment, which will have to be adequately funded.

We recognise the need to demonstrate long-term value for money and we welcome the confirmation of the interests of future consumers, as well as existing ones.

2 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.

We support the current industry structure, which provides a firm basis for delivery of the objectives.

We recognise the need to continue to ensure that incentives are aligned across the energy sector, so as to avoid any potential distortions.

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

We support the move to wider stakeholder engagement. We shall continue to engage with a wide range of stakeholders, including suppliers, customers' representatives, environmental groups, government, agencies and politicians. However, we recognise that the priorities and willingness to pay for improvements vary widely across interested parties. In particular, we are aware that suppliers may well not have the same interests as customers themselves. We shall also ensure that the interests of future customers are not overlooked and that investors' requirements are fully taken into account.

4 Third party modification requests: We set 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. We would keep under review the guidance, including considering the merits of asking government to introduce a formal right of appeal through primary legislation. We would 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.

Energy regulation in Great Britain is already widely recognised as an example of transparent and open regulation, which provides the opportunity for a wide range of parties to participate in the consultation process, if they choose to do so. Parties which are significantly affected already have judicial review available, should they consider the Authority has not acted in accordance with its duties or in a seriously unreasonable way.

We are concerned that the attempt to introduce a third party means of appeal under existing legislation will be counter-productive. We observe a lengthy series of appeals in the telecommunications sector. In our opinion, allowing third parties to request a referral to the Competition Commission would encourage attempts to delay implementation of changes and increase uncertainty surrounding the outcome of price control reviews and also the timing and scale of changes to use of system charges.

A referral to the Competition Commission would inevitably delay the decision making, by at least several months. This would delay investment programmes and delivery of their benefits to customers and society. It would also hold back the progress of government energy and climate change policies. Implementation of other improvements in the price control, such as enhanced incentive mechanisms, would also be “put on hold” and the associated benefits would not be attained and moves towards better regulation would be delayed.

It may effectively block the Authority’s own decision making or, on the other hand, lead to the Authority effectively avoiding making difficult environmental or social decisions on contentious matters and leaving these for the Competition Commission to resolve.

We are particularly concerned that allowing reference on a single issue would encourage parties to “cherry-pick” challenges, which could distort the overall price control package. Furthermore, we are not persuaded that the Competition Commission would ignore evidence on other matters, evidence on which could be submitted during its inquiry. A single issue may be used as a “Trojan Horse” which leads to wider aspects of the price control being re-opened.

We note that the DfT proposes¹ to limit third party appeals to Passenger Focus, as its perspective is judged to be more aligned with that of passengers themselves, and not to establish a right of appeal for airlines.

Overall, we have difficulty in seeing how the Authority can satisfactorily combine its role of determining price controls with that of gate-keeper for third party referrals. We expect such an attempt would lead to widespread dissatisfaction among interested parties and potentially an increase in regulatory risk. We believe that the Authority itself should fully take into account the views and interests of all stakeholders, as expressed through well-justified business plans and the enhanced consultation and stakeholder engagement processes.

5 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.

We support the overall development of primary outputs across the six areas identified through the RPI-X@20 process (safety, reliability, connections, customer satisfaction, environmental and social obligations). It will be important to align the importance and calibration of each measure against each different types of network; e.g. as measures that are important for gas distribution may not apply to the same degree to electricity transmission. It is also vital that only outputs that are measurable, and that are within the control of the licensee are implemented. The development of secondary outputs / deliverables needs to be considered carefully to ensure that inappropriate “inputs” based mechanisms are not developed, which could result in Ofgem appearing to micro-manage the licensees’ decision making.

6 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.

We strongly support the retention of an ex ante price control as it has desirable incentive properties, which is proven to deliver improvements for customers.

We welcome the commitment to inflation indexation of the RAV, which provides reassurance for investors.

We agree that the retail prices index (RPI) continues to be the most appropriate measure of inflation as it is consistent with the financial capital maintenance concept and the use of index linked gilts as an indicator of the real risk free rate. Moreover, some companies have issued index linked bonds

¹ Department for Transport (2009) “Reforming the Framework for the Economic Regulation of Airports – Decision Document”, December

which are also linked to the RPI and rely on that indexation of the RAV to match their increasing liabilities.

We agree with the conclusion² of the independent ONS that “The RPI is the best indicator of consumer price inflation in the UK”.

7 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.

We doubt that simply increasing the price control period to eight years will be sufficient to ensure that companies minimise life-time costs, as there remains considerable uncertainty about developments beyond the end of the price control period. Moreover, the imposition of a mid-term review is likely to focus attention increasingly on the first four years, as there will be concerns that the forthcoming mini-review will, in practice, turn out to be wider than envisaged. We are also unclear as to the circumstances in which a third party may be able to trigger a referral of the mid-term review to the Competition Commission. Furthermore, any referral to the Competition Commission would potentially widen the scope of the mid-term review.

We note that the five year price control continues to be the norm for price control periods set by other regulators and we remain unconvinced that a longer period is necessary for the energy sector.

We would prefer the development of particular longer term mechanisms, where appropriate, which can be explicitly codified in the relevant special licence conditions, such as the distributed generation incentive for electricity distribution, roll-over mechanisms and the TIRG and ENSG provisions for specified electricity transmission projects.

8 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.

We welcome the renewed emphasis on proportionate assessment, as there has been a tendency for price review processes to become increasingly onerous and resource intensive.

We look forward to further discussion on the “fast-tracking” route, including:

- Criteria for selecting and evaluating fast-track candidates
- Timetable for cost of capital decisions
- Position as regards any outstanding aspects of the price control
 - e.g. finalisation of incentive mechanisms and targets
- Impact of potential third party requests for referral to the Competition Commission.

We shall explore this opportunity for TPCR5, which is already underway.

² O’Donoghue, Jim and Wilie, Colin (1998), “Harmonised Indices of Consumer Prices”, Office of National Statistics, 18 March

9 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.

Competitive tendering already plays a large role in delivery of our outputs (e.g. Design and Build contracts for major projects such as major substations). Network operators already face strong financial incentives to optimise delivery of projects.

Encouraging multiple new asset owners into the arena will increase the burden on the system operator in co-ordinating maintenance outages, and may well require a complex commercial arrangement.

Also, not all potential projects will attract sufficient interest from third parties to ensure a competitive, efficient and timely outcome.

Importantly, competitive tendering arrangements must not delay delivery of the government's renewable energy and climate change targets. In particular, we note the lengthy process which has still not finalised an enduring solution for off-shore transmission. This highlights the complexity of and potentially delays in establishing such third party arrangements.

10 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.

We support the development of transparent, upfront, symmetric sharing rules for under- and overspend, as developed for DPCR5.

Care must be taken in the design and calibration of incentives to ensure that they do not distort decision-making and the allocation of resources such that customers preferences are not properly reflected. Inappropriate incentives can unduly focus attention on less valuable activities to the detriment of other activities which customers may value more highly.

11 Principles for ensuring efficient delivery is financeable: We would 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.

We welcome Ofgem's acknowledgement of the role of credit rating ratios in assessing financeability. However, without committing to a comfortable investment grade credit rating, investors will take little comfort from such calculations.

It appears that the major credit rating agencies focus on:

- Neb Debt / RAV
- Post-maintenance Interest Cover Ratio (PMICR)
- Interest coverage ratio.

In particular, we are aware that not all credit rating agencies prefer PMICR to the unadjusted interest cover ratio.

In setting allowed returns, Ofgem should take heed of warnings from investors that funds will not be made available if the return is inadequate. Investors choose from a global range of opportunities, many of which offer higher rates of return.

The overall impact of the RPI-X@20 recommendations would be to increase the duration of cash flows and also to exacerbate the problem of “time inconsistency” in regulatory decisions over long periods, each of which will increase the cost of capital.

In addition, Ofgem will need to allow the costs of raising both debt and equity, which will be significant.

If depreciation lives are extended in electricity, we shall require transitional arrangements to avoid a step change in revenues. The simplest solution would be to adopt longer lives for new assets only, while maintaining current lives for existing assets.

12 Innovation stimulus package: We would 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.

We welcome Ofgem’s recognition that a longer term stimulus package is required to incentivise network operators to participate in facilitating a sustainable energy sector. As identified in the RPI-X@20 recommendations, stimulus is essential to enable innovation on networks that is essential for a sustainable energy sector. We also welcome the view that the stimulus package for electricity networks should be separate from gas networks as both have their own unique challenges and timelines.

Using the framework of the Low Carbon Network Fund (LCNF) developed in DPCR 5 is a sensible starting point for the innovation stimulus package given the effort that has been involved developing this. However, the competitive nature of LCNF has discouraged networks operators from collaborating with one another which is where the greatest benefits from innovation could be achieved. RPI-X@20 recommendations continue to use this competitive nature which we believe will hinder the potential innovation that could be achieved, as network operators are less likely to openly collaborate as they have done under IFI which is not competitive.

However, we would strongly object to opening the innovation stimulus package to non-network parties where licensees are not afforded a lead role. Both IFI and LCNF have encouraged network operators to collaborate extensively with non-network parties such as technology providers, consultancies, energy suppliers and generators. These two funding mechanisms have produced a broad variety of innovation at various levels of research, development and deployment to great success with the networks operators leading the projects. By opening funding to non-network parties, technology may be developed which will be forced upon network operators because it has been funded via this mechanism. The decision of what technology to trial on the network should ultimately lie with the network operators and not Ofgem/the expert panel. The eligibility principals set out in the recommendations for non-network parties could be achieved through collaboration with network operators who would lead projects, rather than granting licences to third parties.

As per the LCNF, commercial innovation is just as important as technology innovation and should play a role in an innovation stimulus package. Regular reviews of the stimulus package would be welcomed as the uptake and benefits delivered from the stimulus are unknown at present and dependent on the nature of the package.