

Electricity North West

304 Bridgewater Place, Birchwood Park,
Warrington, Cheshire WA3 6XG

Telephone: +44 (0) 1925 846999

Fax: +44 (0) 1925 846991

Email: enquiries@enwl.co.uk

Web: www.enwl.co.uk

Rachel Fletcher
Partner, Distribution
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Direct line 01925 846863

Direct fax 01925 846990

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Dear Rachel

Please find attached our response to the open letters relating to the upcoming Gas Distribution price control. This price control represents the first application of the recently announced Sustainable Network Regulation principles and will provide a vital insight into the direction of future price control reviews. Future investor confidence in the sector is reliant on the successful implementation of this price control.

Implementation of RIIO Recommendations

Many of the principles in the new regulatory framework were applied in the Electricity Distribution Price Control Review (eg Outputs, Low Carbon Network Fund, Return on Regulatory Equity, Incentive equalisation) and the RPI-X @ 20 review recognised that they are valuable and transferable additions to the regulatory toolkit. We are comfortable with these concepts as implemented within the DPCR5 framework.

Some other elements of the RIIO recommendations have taken a more radical and principle-based approach. A number of these developments have been robustly challenged by the sector as being unacceptable. Additionally, Ofgem has, to date, failed to properly consider how all the elements of the RIIO recommendations interact and we contend that the collective set of principles presented in the RPI-X @ 20 recommendations would result in an unacceptable overall price review package.

The overall acceptability of the gas distribution price control to customers, stakeholders and network operators will depend on the combined effect of the total package of proposals. The price control review process will therefore be a key test of whether the principle-based RIIO propositions can be translated into the practical application of an acceptable price control.

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 will prove an important enabler of future price control processes as its publication should provide companies with clarity at the start of a control and enable robust and targeted business plans. In particular, a number of Ofgem's assertions on financeability are based on the belief that regulatory uncertainty will be minimised by making this long term commitment. Clearly the publication of a comprehensive strategy document is the first milestone in discharging this responsibility.

Whilst we were encouraged to see that this document has been scheduled for publication within the price control timetable, we believe that the short duration between publication of the RIIO principles and the strategy document, the level of detail required to allow Ofgem to discharge its objectives for the paper and the complexity of moving to the new arrangements will not allow Ofgem to produce such fundamentally important strategy documents for two price reviews in the timescales suggested. The objectives for the strategy paper were to allow companies' to produce robust, high quality business plans and to mitigate some of the concerns by increasing regulatory certainty. Unless the strategy document provides a significant amount of detail to fit around the principle-based recommendations, all other elements of the RIIO price controls will not be effective. Rushing to publish this document may generate unforeseen consequences that result in suboptimal price controls for customers and companies' as well as undermining investor confidence in the sector. Ofgem should work with the companies' on the strategy document to determine the required content and level of detail to enable the submission of high quality business plans. This may require a longer consultation period for the strategy paper but will allow a more appropriate and substantial publication.

Outputs

The use of outputs in the price control provides the regulator and the networks with demonstrable delivery mechanism and an important framework to discuss the future requirements of the networks. We have noted that Ofgem have not specified any Tier 1 outputs relating to network risk. Given its importance in the DPCR5 discussions, this is a notable and surprising omission. We urge Ofgem to commit to working with companies to develop comparable Tier 1 metrics. This will enable Ofgem to take a more complete view as to the efficacy of company proposals.

We are also concerned that Ofgem has failed to recognise the importance of secondary outputs. As we noted in our response to the RIIO proposals, secondary outputs represent the long term strategic elements of a company business plans. Ofgem's desire to retain levels of flexibility and network responsiveness to an uncertain environment will be delivered through secondary outputs.

Incentives

Ofgem must ensure that the incentive schemes they consider implementing satisfy the following five simple tests:

- Is the desired output clearly measurable?
- Is performance controllable by management?
- Is the mechanism suitable for the objective?
- Is the incentive rate reflective of the externalities?
- Is the rate adequate to drive the desired behaviours?

If Ofgem plan to calibrate the incentive rates in collating their overall price control proposals, they must ensure that this calibration takes into account the long term value delivered by the incentive scheme. A key shortcoming of the DPCR5 RORE analysis was that it focussed on short term measures rather than long term value.

We note Ofgem's proposal to use a similar methodology to the DPCR5 electrical losses incentive to address concerns with shrinkage. The DPCR5 losses incentive scheme fails to meet the requirements of appropriate incentive mechanism as it increases the risk profile of a company in a manner that is uncontrollable by companies without providing any certainty of reward for investment in loss-reducing activities. Given the identified issues with the losses methodology and its sensitivity to external factors, we do not believe that this methodology should be imposed upon the Gas Networks.

Innovation

We are pleased that Ofgem recognises the importance of research and development in identifying potential step changes leading to innovative network performance. It is important that Ofgem clarifies how these activities will be funded and incentivised under each price control.

Stakeholder engagement

We note that the proposed Ofgem-led enhanced stakeholder engagement programmes for both price controls do not include any regional representatives. Future price controls will depend upon regional engagement and regional plans will be based upon the relationships and requirements of the local stakeholders. Each network company may be asked by its customers to adopt a different risk profile, depending upon their needs and appetite to adopt commercial arrangements. Ofgem must take account of these views to understand the networks' business plans and include representatives of all regions on its price control review forum.

Financing

The RIIO initial proposals included a significant number of principles which would create substantial issues for the companies if they remain unchanged. Such fundamental changes will introduce issues which network operators and their investors will need time to understand. Ofgem must therefore provide a significant amount of information and more clarity of its approach to financing networks. This must include publishing detailed financial models showing proposed revenue setting methodologies and how cash-flow assessments and ratio tests will be assessed and utilised early in the process.

Fast Track Price Controls

We note Ofgem's desire to undertake fast track price control reviews by assessing delivery of outputs, quality of business plans and effective stakeholder engagement. It is not clear to us how Ofgem intends to objectively compare the performance of companies in these areas in order to select the companies to be fast-tracked. Ofgem must publish its criteria for fast track status including:

- how the initial sweep of plans will be conducted and compared;
- how the relative quality of stakeholder engagement will be assessed; and
- how, in the absence of outputs, historic performance measures will be considered.

The concept of Fast Track price controls could, in principle, require efficient 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 if the proposal to move to eight year price controls is not amended to reflect the recommendations of all network companies. It is also important to recognise that that in previous price reviews a combination of Ofgem's over-zealous initial stance on some issues and lack of understanding of the detail of other issues would have resulted in unacceptable price control proposals. These two factors could mean that fast track companies would be unable to accept price controls that will not become sustainable until the issues for all companies have been concluded. The strategy document must address these concerns and offer a significant reward for fast track companies to make price controls acceptable at an early stage in the process.

Price control timetable

The recent DPCR5 process encountered a number of complications and delays which impacted on Ofgem's and companies' ability to consider each others' position on a number of key areas. The most significant of which were errors in the Ofgem analysis which resulted in the reworking and republishing of much of the comparative efficiency analysis in both the May 2009 document and the Initial Proposals. It will also be important for the timetable for the Gas Distribution review to be able to take account of the final principles that will emerge from the RIIO publication and

the interdependency between transmission and distribution plans. Therefore, the timetable needs more contingency for such issues to be built into it and a clear set of options for how to deal with such issues should they arise again.

We have noted a number of issues in the published timetable

- Ofgem has not allowed any time for the third party challenge process.
- One of the key lessons from DPCR5 is the importance of starting licence drafting and RIG development early.
- Running two price controls in tandem with joint resources is likely to be a difficult process. Ofgem must satisfy itself that it has enough resources to deliver both controls in the allotted timescales. It is better to address this issue early than attempt to catch up.

We would be very happy to assist your teams in any aspects of the price control. If we can be of assistance please do not hesitate to contact me or one of my team.

Yours sincerely,

Paul Bircham
Customer Strategy and Regulation Manager