

Maire Williams  
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Ofgem  
9 Millbank  
London  
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12 September 2012

Dear Maire,

**RE: Strengthening strategic and sustainability considerations in Ofgem decision making**

EDF Energy welcomes the publication of the “Strengthening strategic and sustainability considerations in Ofgem decision making” discussion paper. We support the objective of well-informed, transparent, evidence-based decision making, since the development of a robust impact assessment benefits both industry and consumers. The following points summarise our position:

- The delivery of Government policy objectives must take priority over Ofgem’s strategic and sustainability considerations. In particular, in working out how to interpret its duties, Ofgem will have to recognise the broader constraints placed on licensees under environmental law.
- The most significant issue facing the impact assessment is the danger of double counting the impact of the asset on sustainability. Other policies may have considered the asset’s impact. For example, the cost-benefit of environmental permit conditions for NO<sub>x</sub> and SO<sub>2</sub> emissions to air and water usage for a generation asset will already have been assessed and judged as socially optimal by other policy areas. Consequently, impacts that are addressed directly by other regulation may not be appropriate for inclusion in an Ofgem decision impact assessment.
- The consultation recognises the complexity of the task facing the regulator but does not acknowledge that the robustness of the results of the assessment and their interpretation will almost certainly be incorrect over the 40 year forecasting period. The costing of environmental impacts has a particularly high degree of uncertainty and complexity. Ofgem needs to develop a framework that provides consumers and industry participants sufficient clarity to understand how the impacts have been assessed and monetised, and how these have influenced Ofgem’s decisions.
- By making a distinction between medium term strategic and long term sustainability effects there are two main risks:
  - It could have the effect of policy makers assuming that the key “strategic effects” identified by Ofgem will only manifest themselves in the medium term and that sustainability effects will only occur in the long term. Conversely, it could mean that sustainability considerations would not be taken into account in the medium term or strategic considerations in the long term. However, Ofgem states that “the distinction between the

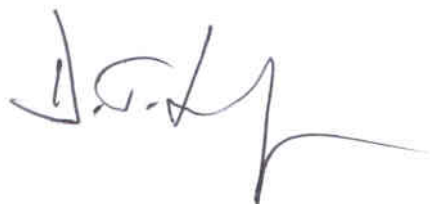
two legs is not rigid" (2.5 page 12) and indeed we consider the distinction unhelpful. Strategy and sustainability should be considered together.

- It will not be easy to predict the interaction between the monetised value of security of supply in the medium term and its potential impact on the environment long term.
- We recognise Ofgem's efforts to develop its analysis outlined in its paper on real options theory (Appendix 2, Ofgem's March consultation "Real Options and Investment Decision Making") and the discussion on the use of the Shannon Weiner Index to determine the extent of biodiversity in a habitat (p21 of the consultation). However, it is important to improve Ofgem's interpretation of its own findings. The decision will only be as good as the judgement applied to the information created by this process.

Our detailed responses are set out in the attachment to this letter. Should you wish to discuss any of the issues raised in our response or have any queries, please contact my colleague Ravi Baga on 020 7752 2143 or myself.

I confirm that this letter and its attachment may be published on Ofgem's website.

Yours sincerely,

A handwritten signature in black ink, appearing to read "D. Linford".

**Dennis Linford**  
**Corporate Policy and Regulation Director**

## **Attachment**

### **Strengthening strategic and sustainability considerations in Ofgem decision making**

#### **EDF Energy's response to your questions**

##### **Risk of Double Counting**

The most significant issue facing the impact assessment is the danger of double counting the impact of the asset on sustainability. Other policies will have considered the asset's impact. For example, the cost-benefit of environmental permit conditions for a generation asset will already have been assessed and judged as socially optimal by other policy areas. Consequently, impacts that are addressed directly by other regulation may not be appropriate for inclusion in an Ofgem decision impact assessment.

Where an impact of an asset is already been addressed by other regulation (e.g. environmental control of emissions to air), the costs of that impact will already have been assessed in determining the appropriate level (and associated benefits) of abatement. If these have an impact on costs (and the corresponding benefits of impact reduction) are also included in assessments for other policy decisions then they will be accounted for twice in public policy decision making. The resulting combined outcome will not be socially optimal.

A further challenge for assessing environmental consequences of indirect policy decisions is the difficulty in establishing a robust counter-factual for comparison. This is particularly true when an assessment is made of potential displacement of a particular generation category, as other factors may affect the overall outcome and actual emissions.

##### **Complexity Issues**

The document acknowledges that strategic and sustainable considerations are complex, uncertain and highly sensitive to assumptions underpinning monetisation of sustainable and strategic considerations (p3). The problems that Ofgem is trying to solve may well be unsolvable with any degree of certainty given the 40 year time frame. The costing of environmental impacts has a particularly high degree of uncertainty and complexity. In the case of air pollution, there is a considerable technical debate on the degree of impact from different emission categories.

Ofgem's decisions will impact all consumers who will ultimately be financing the projects. In this respect considering other valuation methodologies besides NPV, such as real option theory, is a positive development in impact assessment policy. However, we have to be realistic on what it is possible to achieve.

## **Structured approach**

Ofgem's solution is focused on creating "a more structured approach" to identify and strategic and environmental considerations. While a more structured approach is desirable in its own right, it is less clear in the document how "structure" necessarily solves the issue of complexity, or how to monetise the factors identified in the table on page 4. We see that a structured approach could enhance consistency of decision-making through standardising Ofgem's framework which we welcome.

There is a need for stakeholders to understand how Ofgem's sustainability considerations have influenced the decision.

## **Medium term strategic and long term sustainability**

In the treatment of strategic and sustainability decisions in impact assessments, the degree of political consensus on the objectives is in effect what the regulator is attempting to forecast over 40 year period. The monetised value of sustainability could substantially change if the effects of climate change become more apparent to consumers than they are now for example. Also, by making a distinction between medium term strategic effects and long term sustainability effects, the problem is compounded as it might always seem attractive to invest in the medium term.

## **Suggestion: Concentrating effort on understanding the conditions for good judgement**

Ideally Ofgem should think about how they can create processes to create conditions for good judgement. This is just as important as innovating its methodological concerns.

Ofgem should also consider the development of more sophisticated interpretations of relevant information derived the models identified in the document. Insights into Behavioural Economics are just as relevant to regulators as there will, for example, be issues of confirmation bias in interpreting the information from Ofgem's models.

**EDF Energy**  
**September 2012**