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Managing Regulatory Reviews: The Challenges Faced by Distribution Network Businesses

Point of View by Harriette Meynell

Managing Regulatory Reviews

The Challenges Faced by Distribution Network Businesses

Background

Despite the many benefits that follow the privatisation, deregulation and unbundling of utilities, some natural monopolies remain just that — natural monopolies — be they in water, gas or electricity. If anything, third party access to the pipes and wires makes it even clearer that the networks are natural monopolies. The consequence is that whilst prices in the contestable parts of the markets can be governed by competition, it is regulation that has to set the prices for the monopoly network services.

In the UK at least, utility regulators have worked hard to identify the areas where a true natural monopoly exists and have developed regulations with similar incentive mechanisms to a competitive market. As a result, the natural monopolies of water pipelines, gas and electricity transmission and distribution networks are subject to periodic price control regulation, and also ring-fenced from other businesses under shared ownership.

Using the example of the British electricity distribution sector, this paper illustrates the complexities and challenges of the periodic regulatory review process. Also identified are some of the strategies that distribution network companies must develop in order to achieve a successful review outcome. We have focused on the British electricity distribution sector since it is currently in its fourth regulatory review cycle and the regulatory process has evolved since privatisation.[1] Australian price control reviews, which are largely based on the British model, have followed a similar form and we might expect the same to be true as European utilities open their networks following EU directives on open access.

Objectives of Price Control Reviews

In Britain, Ofgem[2], the energy industry regulator, cites its main objectives for distribution price control reviews as providing incentives to:

- ensure distribution network operators (DNOs) develop and operate their networks efficiently;
- provide an appropriate quality of service to consumers;
- ensure DNOs can finance their licensed activities efficiently; and
- further wider Ofgem/government objectives regarding competition and the environment.[3]

The regulatory review process is critical to British distribution businesses, both electricity and gas, as Ofgem has the power to decide on the level of prices that companies can charge for use of their distribution networks. Historic outcomes of previous electricity price controls have resulted in price cuts between 10% and 15% and corresponding reductions in the revenue for these distribution companies.

1 Evolved in the Darwinian sense of becoming more complex. Whether the regulatory process has improved as a result is an interesting question, but out of the scope of this paper.
2 The energy regulator in Great Britain. Ofgem is currently setting the next five-year price controls (2005/6 to 2009/10) for the 14 British electricity distribution network operators.
3 Taken from "Electricity Distribution Price Control Review - Initial Consultation", Ofgem, July 2003.

The British Electricity Distribution Price Control Review Process

Every five years, the regulator decides on the level of prices that companies can charge for use of their electricity distribution networks. Figure 1 depicts the overall regulatory review process for DNOs in Britain.

The regulatory reviews are thorough, with every aspect of operating expenditure and capital expenditure coming under the microscope. The whole process lasts for approximately 21 months. This means that DNO's spend almost 40% of their time (two years in five) in a regulatory review process - it is therefore critical to get it right.

After Ofgem has published its final proposals, companies have one month to determine whether they accept or reject them. If companies do not accept the regulator's proposals, this triggers a referral to the Competition Commission - which has its own risks and costs attached. To date, only one electricity DNO has rejected the regulator's final proposals, Scottish Hydro Electric, in 1994.

The rejection was on the basis that allowable revenue was too low to provide a satisfactory level of service to customers and provide shareholders with an adequate return on investment. The commission determined that price reductions in distribution should be over and above the regulator's proposals, though it did allow 10% more capital expenditure than the regulator.

Dealing with the Regulator

While Ofgem has obligations to ensure the companies it regulates can finance their affairs, its principal duty is to "protect the interests of present and future consumers wherever appropriate by promoting effective competition". This effectively means that Ofgem, in common with many other regulators around the world, is obliged to put consumer interests before those of the regulated companies.

Because of this, a key dilemma for distribution companies is how and when to push back against the regulator. On what issues is the regulator likely to give ground? What regulatory elements are deemed "unacceptable"? What evidence is required to change views? In effect a price control review is a protracted, data intensive negotiation with the regulator, with both sides "giving ground" to varying degrees.

In the UK, we have observed that wherever possible regulators will try to "divide and rule" between the companies subject to regulation. In this way a regulator can exploit the differences between, for example, company strategy, approach to maintenance (asset repair or replacement) or capitalisation policy impacting the regulatory asset value.

Figure 1 — Simplified overview of GB distribution price control review process

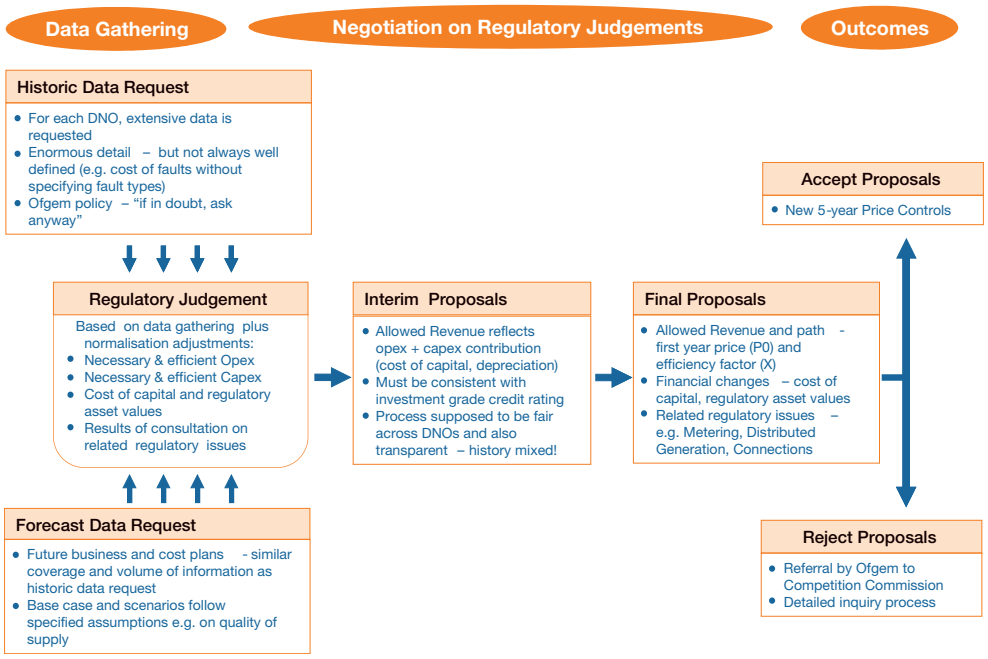
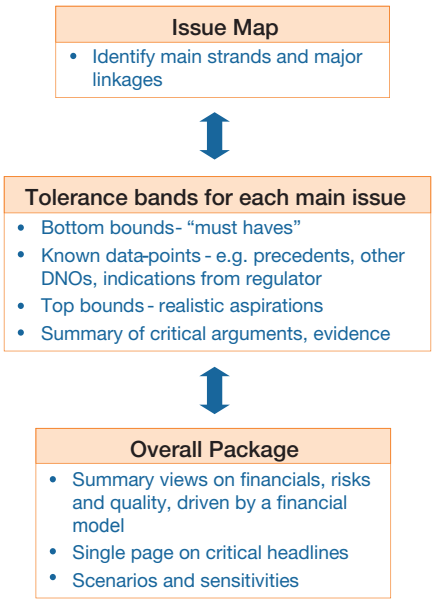


Figure 2 — Components of a negotiation framework



Though regulatory reviews follow a structured process (by the issue of consultation documents and draft proposals), much is done outside of this structure to influence decision makers. We at Capgemini believe it is important for distribution companies to implement a negotiation framework to enable all decisions within the regulatory review to be seen in the wider context (qualitative and quantitative). It also facilitates pro-active management of the regulator — critical in maintaining the strategic edge throughout the lengthy review process.

A key element of the negotiation framework is a robust financial model that links the main business drivers, enables scenarios to be easily modelled and provides quick, easy to understand results of, for example, cash flow, profit, key ratios, financing implications. But it is also more than this (see Figure 2).

A robust negotiation framework can play an integral role in meeting a number of key needs within and beyond the price control itself:

- a shared vision of what the future business plan really means;
- a framework to identify the regulatory challenges and success criteria … and the triggers to reject proposals;
- the linkage of business and financing challenges, in addition to links between outturn and forecasts;
- help with tracking negotiations and submissions on individual elements
- help executives lead the negotiation process;
- the ability to evaluate performance incentives and any upside potential; and
- the discipline to provide "evidence" for both regulators and others.

By fulfilling these key needs, a negotiation frame-work can go some way to enable a distribution business to overcome the challenges of multi-faceted price control reviews.

Implications for Newly Unbundled Distribution Businesses

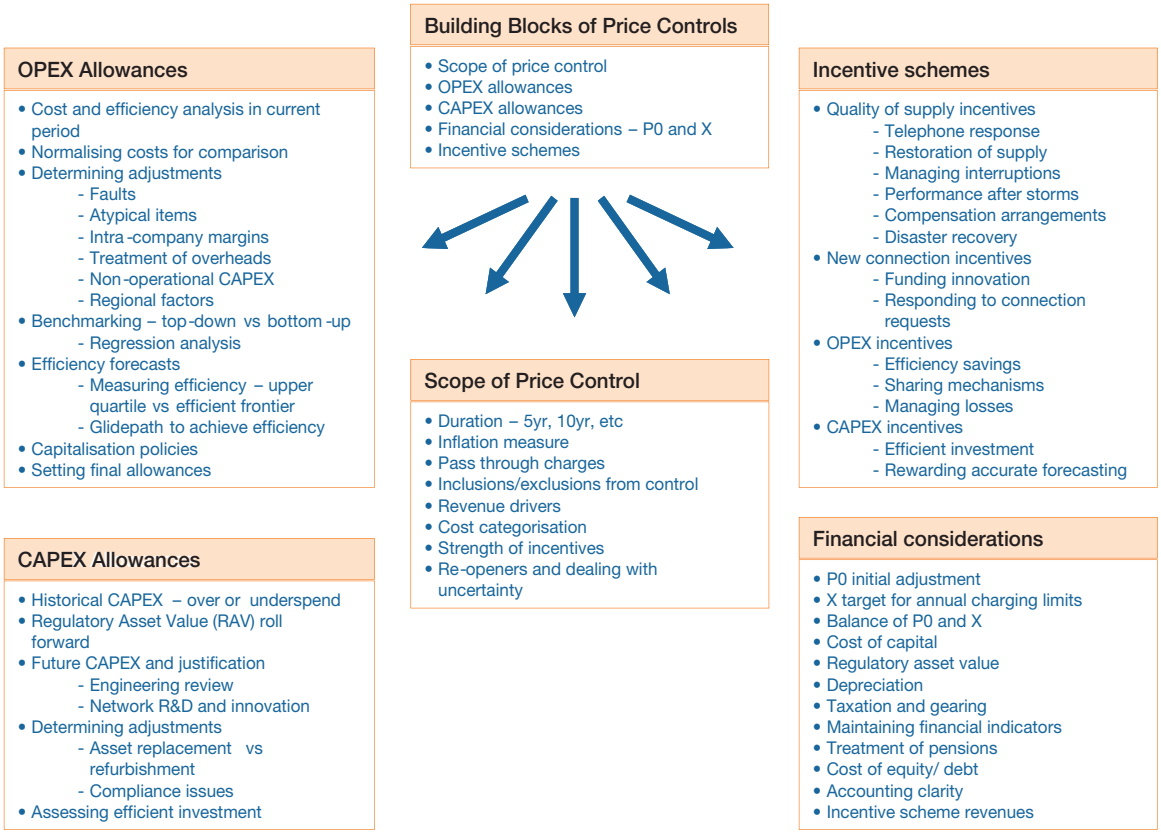
Across Europe, unbundled distribution businesses, as natural monopolies, will be subject to some form of price control in the future. Whilst the process may not be as data intensive as in Britain (currently in its 15th year of electricity distribution price controls), many of the same principles will need to be addressed:

- understanding the real cost drivers behind operational expenditure — network length, customer numbers, units distributed, etc;
- tracking and benchmarking costs — capital and operational expenditure;
- performance management to ensure quality of supply (interruptions, etc) and the creation of incentives to achieve this;
- effective asset management to determine regulatory asset values and, more importantly, optimising asset use and longevity (since initial price controls, at least, focus on cost reduction);
- clarity on true pass-through costs and what elements of the business should be excluded from price controls;
- accounting consistency across companies (including the prevention, or at least identification, of cross-subsidy) — this should not be underestimated, for example, Ofgem has still not achieved agreed and consistently applied definitions for DNO regulatory accounts; and
- anticipating structural change — unbundling is not a one-off exercise since regulators will continue to open up more areas of the business to competition.

Figure 3 below shows why these principles are important, since all make up the "building blocks" of distribution price controls.

Lessons learnt in the UK market are likely to equally apply to European distribution companies and network operators. Given the current unbundling discussions across Europe's energy markets, these lessons could also be used to facilitate the initial set-up of price control review rules between industry and regulators in Europe.

Figure 3 — Building blocks of distribution price controls



Challenges of Distribution Price Control Reviews

With risk of price cuts of 10% to 15% on a periodic basis, the impact of regulatory price control reviews is significant. At Capgemini we have extensive experience of assisting distribution companies through the price control process. We have found that the main challenges companies undergoing review face are:

Strategic Overview

Developing an ability to look at the overall regulatory proposals — since so many factors are interlinked (e.g. cost of capital, capital investment and credit ratings) it is important to understand the overall impact of the proposals and make decisions on the basis of these interrelationships;

Business Alignment

Building a common view of what a successful outcome looks like — all parts of the business must agree the business plans submitted to the regulator, otherwise there is no common starting point for negotiations;

Incorporating price control outcomes into future business plans — price controls are not independent of the day-to-day business, they should be incorporated into the fabric of management reporting and cost/expenditure forecasts;

Data Management

Providing historical and forecast information required by the regulator — regulatory accounts are not enough due to differing accounting policies across companies. Regulators also tend to require substantial amounts of additional information;

Management of Process

Being proactive throughout the (lengthy) regulatory process — in the face of the requirement to respond to large information requests from the regulator, it is imperative that companies try to maintain a strategic lead and anticipate what is coming next;

Securing a project team with sufficient coverage from the business — distribution price control reviews consider all areas of the business. Finance expertise will not be enough since the regulator will conduct engineering reviews of future projects;

Maintaining company expertise and knowledge — most reviews have historically required headcount reductions, which makes finding people with the relevant experience to lead a business through the regulatory review more difficult. In addition, staff are reluctant to leave line roles to join a temporary project team;

Achieving consistent communications — in a protracted regulatory process, which relies on multiple contact points (formal and informal) at all levels, it is difficult to keep the whole organisation "on message." Over time, everything a company submits to its regulator sets a precedent for how it must explain itself in the future. There are many examples of value being destroyed by the precedents set in "off message" exchanges between staff and their regulator; and

Maintaining a view on how well/badly the review is going — it is important to understand what future investment projects are at risk, the impact of efficiency targets and how is your DNO doing relative to others (to identify potential allies).

Conclusions

Regulatory controls for distribution companies fundamentally drive the economics and profitability of distribution companies. Regulatory reviews are a key part of establishing a fair and reasonable return and the appropriate incentives. The management of these reviews are therefore of primary commercial significance.

As we have shown, the challenges for companies facing these reviews are substantial. The effort required to respond to these reviews is substaintial and should not be underestimated. A successful outcome — one where the company has its plans approved by the regulator, is more likely if the company:

- can maintain a strategic overview of the proposals;
- ensure senior management understand the importance of the review;
- have systems and processes in place to provide the information that the regulator wants;
- tightly manage the regulatory review process; and
- ensures that its regulatory team can draw on a wide base of expertise — internally and externally — to support the process.

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