

**Potential scope for user participation in the GB energy regulatory framework,  
with particular reference to the next Transmission Price Control Review**

**Report to Ofgem**

**Stephen Littlechild and Nigel Cornwall**

**28 March 2009**

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**EXECUTIVE SUMMARY**

*Background and approach*

Ofgem has asked us to examine the scope for different ways of increasing user participation in the GB energy sector regulatory framework, and to provide a short report on this matter. This is one of the range of options that Ofgem is exploring during the 'visionary phase' of RPI-X@20. For concreteness, we have been asked to consider the specific case of the forthcoming fifth electricity transmission price control review (termed TPCR5).

We have first looked at the context for this study, in terms of a) existing measures to increase user participation and b) the issues likely to arise in transmission regulation that could impact on the next generation of price controls.

We have looked in detail at four potentially relevant approaches that have actually been used in other jurisdictions or in other markets. These are:

- the Public Contest Method in Argentina, whereby electricity transmission users propose and vote on possible transmission expansions, with construction, operation and maintenance of approved expansions being put out to competitive tender;
- the constructive engagement approach adopted in the UK by the Civil Aviation Authority (CAA), the airports regulator, whereby the regulator proposes that airports and airlines discuss and seek to agree on specified components of the price control 'building block' calculation which can then be taken into account by the regulator;
- negotiated settlements in parts of the US and Canada, whereby energy utilities and interested parties such as network users and customer representatives negotiate and seek to agree on the whole or part of a forthcoming price control (or other issue), which is subsequently typically adopted by the regulator; and
- negotiated services in Australia, whereby the regulator specifies criteria for identifying services to be negotiated and specifies the criteria for determining terms and prices, and the utility specifies its framework for negotiating with users and customers, and the regulator or an arbitrator determines unresolved disputes.

The key features of each approach are summarised at Table 1.

In practice, there is some variation in the way each of these approaches is applied, and to some extent they blend into each other. It would be open to Ofgem or any other UK regulator to consider a mix or modified form of any of the above approaches. It is also possible that other approaches may be available from other jurisdictions. The approaches we have examined are not intended to be definitive, but we believe that they constitute a useful basis for further consideration of user involvement.

**Table 1—Summary of approaches**

<b>Method</b>	<b>Main area of application</b>	<b>Nature of process</b>	<b>Status of outcomes</b>
Public contest method	Argentina: electricity transmission (new investment). Project by project (>\$US2mm), initiated by users within specified regulatory framework.	Users propose and vote for expansion projects, with votes based on first two years of expected usage. Construction, operation & maintenance of approved projects put out to competitive tender. In a provincial sub-transmission network, users have agreed a ten year investment plan to identify eligible schemes.	Binding on parties, not open to change by regulator.
Constructive engagement	UK: airport price control reviews. Application & scope proposed by regulator. CAA suggested stakeholders focus on traffic forecasts, quality of services and capex.	Consent of agreement then subject to wider consultation by the regulator as part of process of price setting. Failure to agree means default to traditional price control process.	Regulatory discretion as to how far to take account of agreement, but in practice areas of agreement have been largely incorporated.
Negotiated settlement	US, Canada: utility sector, especially energy. Coverage at discretion of the parties, typically rates or tariffs with some extension to issues such as investment projects, quality of service and incentive schemes.	Some regulators have encouraged negotiated settlements, others have not. Some US consumer groups have been critical of settlements. Failure to agree means default to traditional regulatory process. Where appropriate regulators have facilitated participation of smaller interested parties. In Canada, regulator has sought to facilitate negotiated settlements by providing direction on key financial parameters (cost of capital). In Florida, the Public Counsel has been a major participant.	Agreements are binding on the parties but subject to a regulatory finding that rates are just and reasonable. In practice the settlement is usually accepted by regulator.
Negotiated services	Australia: electricity transmission and distribution. Third party services and site-specific terms for both electricity distribution and transmission. Slightly different coverage for transmission and distribution.	Considerable prescription of procedures and negotiating parameters is set out in the National Electricity Rules. The network service provider must publish guidelines and negotiating principles. Arbitration is by the regulator for distribution and an external expert for transmission.	An agreed settlement is achieved on the negotiated service or services. The network user accepts the proposed offer or refers any disagreement to an arbitrator.

Our assessment has benefited from comments made at a small discussion group facilitated by Ofgem on 26 January 2009.

## *Conclusions*

The main conclusions we draw from our assessment and the limited discussions to date are as follows:

- in some respects increased user and consumer involvement are already being incorporated in electricity regulation in Britain, for example through:
  - the Consumer First initiative—a programme of research and engagement commenced in March 2007, which Ofgem says it has designed to improve its “understanding of the issues that matter to consumers”;
  - an instruction to distributors to engage a wider group of stakeholders in the development of their business plans and forecasts for the distribution price control review presently underway (DPCR5);
  - refashioning the annual system operator (SO) incentive setting process so that the initial stages are conducted between the licensee and grid users;
- there is scope further to increase the involvement of network users and consumers in price control reviews generally, and in the forthcoming transmission price control review in particular;
- all four of the approaches considered have potential benefits, and points of direct or potential relevance to GB policy and more specifically to the RPI-X@20 review. They also have certain difficulties or limitations with regard to their transposition into the GB regulatory framework;
- a summary of the pros and cons of the four approaches is at Table 2, with the main points being:
  - the Public Contest method could help to ensure that the future investment programme does not go beyond what users are willing to pay for, and putting expansion projects out to tender could help to ensure lower cost construction, and in these respects could be relevant in particular situations (e.g. on the periphery of the GB transmission network). However adoption of this approach would need a change in the statutory framework in GB, could present difficulties in defining a new set of rules for determining the votes of each transmission user, and could involve a limitation in the powers of the regulator that could be unacceptable in GB;
  - constructive engagement has not been without difficulties in the UK airports sector but agreement has been reached on significant elements of airport price controls, lessons have been learned and a more robust regulatory framework is being put in place. The approach is flexible and able to focus on those issues where constructive discussion and agreement seem most likely (provided the regulator’s specification is not unduly restrictive), leaving to the regulator those issues where agreement seems less likely. It would not need any change in the GB statutory framework;
  - negotiated settlements would enable utilities and users to negotiate and agree features of a price control that were of particular significance to them (such as capital expenditure

**Table 2—Summary of pros and cons**

<b>Method</b>	<b>Pros</b>	<b>Cons</b>	<b>Other comments</b>
Public contest method	<p>Investments are user driven—there is a clear trigger. This creates a presumption that design and timing of investment programmes would be efficient.</p> <p>No stranded asset risk.</p> <p>Clear methodology for allocating costs.</p> <p>Evidence that competitive tender has produced significantly lower costs.</p> <p>Reduction in role of regulator.</p>	<p>Would require legislative changes in GB.</p> <p>Reduction in role of regulator could cause concern to some stakeholders.</p> <p>Cost allocation rules could be more difficult in meshed system.</p> <p>Raises wider issues:</p> <ul style="list-style-type: none"> <li>▪ reversion to deep charging?</li> <li>▪ compatible with current or proposed access regime?</li> </ul>	<p>About 25 applications over about 15 years, albeit constrained by macro-economic crisis and partially superseded by government-initiated transmission expansions.</p> <p>Geared to individual projects but can be consistent with longer-term transmission development plan.</p>
Constructive engagement	<p>Allows regulator to invite service users to negotiate on issues where regulator considers this will be productive.</p> <p>Allows parties to focus on aspects of greatest importance to them.</p> <p>No legislative change needed in GB.</p> <p>Could add significantly to scope of user participation in traditional price control setting.</p> <p>Evidence of improved information provision and understanding at main BAA airports (albeit with some qualification).</p>	<p>Allocation of issues by regulator may unduly constrain parties.</p> <p>Uncertainty over regulatory ‘buy-in’, or attempts to influence regulator, may discourage participation and negotiation.</p> <p>There have been concerns about information provision, ‘capex creep’, lack of arrangements for arbitration in event of failure to agree, and preservation of interests of future users and the public interest.</p> <p>Application beyond airports needs consideration, as does question of how to involve all relevant users.</p> <p>And the issue of how to bring to bear governmental concerns or wider public interest considerations also needs to be addressed.</p>	<p>Limited and mixed track record.</p> <p>Wider scope could require development of more comprehensive procedures and guidelines.</p> <p>Would require clearer demarcations on scope and residual role of regulator.</p> <p>Post agreement process could necessitate wider third party engagement to ensure appropriate levels of consultation.</p>
Negotiated settlement	<p>Allows service users (including final consumers) to determine issues of importance to them.</p> <p>Possibility of part settlement means that approach does not depend upon participants agreeing all outstanding issues.</p> <p>Flexible—has taken a number of forms to suit requirements of participants.</p> <p>Evidence of substantial achievements and benefits for users, including final consumers.</p>	<p>Mixed views have been expressed about merits of settlements.</p> <p>Some concerns in some US jurisdictions that:</p> <ul style="list-style-type: none"> <li>▪ ordinary consumers could be worse off;</li> <li>▪ settlements mean less transparency; and</li> <li>▪ regulators ought to determine such issues as a matter of principle.</li> </ul> <p>How to involve all relevant parties needs to be considered.</p> <p>And the issue of how to bring to bear governmental concerns or wider public interest considerations also needs to be addressed.</p>	<p>Approach has been applied in N America in a wide range of circumstances over a long period of time.</p> <p>Requires positive encouragement and clarification of stance of regulator.</p> <p>Process involving wider engagement of specific types of stakeholder might necessitate further third party engagement to ensure all interested parties are consulted.</p>
Negotiated services	<p>Provides for bespoke services and therefore flexibility.</p> <p>Permits choice as users can stipulate quality levels on dedicated services, upgrading service or lowering costs.</p> <p>Consequently may stimulate innovation.</p> <p>Delivers greater engagement of service users.</p>	<p>Does not help with reset of conventional price control, which is the focus of the RPI-X@20 review, and therefore would have marginal application.</p> <p>Choice is offset by high level of prescription for parameters of negotiated deal.</p> <p>Does not accommodate end consumers.</p>	<p>Similar application already exists in Britain through excluded services regime, albeit in less prescriptive form.</p>

programmes, service quality provisions and incentive arrangements). Using such an approach might set an unduly high hurdle to overcome if it is expected to deliver agreement on the whole range of issues to be covered by a future price control, but that would be equally true of constructive engagement, and in practice partial negotiated settlements are sometimes agreed that leave unresolved issues (such as the cost of capital) to the regulator. It would be necessary to ensure that the interests of all parties, including Government departments where appropriate, were adequately taken into account in the negotiations; and

- the Australian negotiated services approach is intended to facilitate discussion and agreement for certain services, especially where services have some bespoke element or where different service levels might be feasible. In this context some elements of the approach are already applied in GB through existing rules for excluded services albeit on a more limited basis. However it would not seem significantly to extend the role of users or customers in the process of resetting price controls per se, and the same limitation would apply if the same practices were adopted in the UK;
- at this stage the most promising prospect for further exploration, at least in the context of a periodic GB transmission price control review, would seem to be an approach based on constructive engagement. Provided that it is applied with sensitivity to the preferences and aspirations of the parties, it could achieve the potential benefits of the negotiated settlements approach within the context of the GB regulatory framework and could add significantly to the present extent of user participation there;
- this approach would need to be suitably modified to reflect the particular conditions of the energy sector and TPCR5; and
- more research is required as to how such an arrangement could and should be developed and applied.

### *Implications for Ofgem*

Even though it would not involve any change to the statutory framework, any shift to a constructive engagement approach would require certain changes to the way Ofgem leads the periodic regulatory review and to Ofgem's own conduct. For example, in order to implement constructive engagement for TPCR5, Ofgem would need to indicate clearly its commitment to such an approach and to set out the main elements of the process involved.

Specifically Ofgem would need to:

- provide greater clarity on its intended role and the roles of participants with respect to the reorganised review process;
- begin the consultation process sufficiently early to enable greater industry and consumer participation, including in scrutinising the transmission companies' business plans;
- indicate those issues on which it would particularly welcome constructive engagement between the transmission companies and their users (which might be similar but not identical to those issues indicated by the CAA, taking into account the initial views of the potential participants and without being unduly restrictive as to the issues on which discussion and agreement might be invited);

- consider whether the participating stakeholders adequately represent the interests for which Ofgem has responsibility and, if not, take steps either to ensure adequate representation or to communicate to the parties Ofgem's views on the interests of such parties;
- put in place analogous procedural provisions to those proposed by the Competition Commission for the airport sector, and presently in the course of implementation by the CAA;
- request the transmission companies to establish appropriate discussions with key stakeholders, including grid users and consumer representatives, where the latter should reflect smaller as well as large users. Ofgem could usefully give thought to encouraging the formation of a user group to participate in the process;
- specify a time-frame over which negotiations should take place, which might include deadlines for particular decisions so as to enable Ofgem to take forward the other aspects of the review consistent with the overall price control review timetable;
- indicate any conditions that would need to be satisfied by the constructive agreement process, including with respect to reflecting and protecting the interests of parties not at the table (including government departments); and
- specify how it would proceed in the event that such a constructive engagement process failed to make the hoped for progress and/or where agreement might not be reached.

Ofgem would also need to:

- require the transmission licensees to provide the information necessary to facilitate informed discussion on these matters, including that needed for each licensee to develop and publish in a timely manner a suitably detailed business plan in advance of negotiations; and
- in doing this also encourage the transmission operators to make relevant additional data available where reasonably possible.

These steps would not of course preclude Ofgem from continuing to explore and implement other types of consumer engagement, either in the price control review or in other regulatory activities.

# 1. Introduction

Ofgem has noted the successes of the present RPI-X approach to setting network price controls, but also some limitations. Its RPI-X@20 review is considering whether changes need to be made to the regulatory framework. During the ‘visionary phase’ of RPI-X@20 the focus is on understanding the potential limitations of the existing framework and considering a range of alternative options. An increased role for network users and consumers is one idea (among several) being reviewed, though Ofgem has said further work is required across all these options before any change can be advocated.

Some commentators have argued that such approaches offer a quicker, less costly and more convenient means of determining regulated outcomes; others suggest that they allow for more creativity and innovation, and an approach that is better tailored to the needs of the parties concerned. Yet others fear that they could disadvantage parties not involved in the negotiations, or might involve an abdication of responsibility by the regulator.

We have been asked to examine the scope for different ways of increasing user participation, more specifically that of network users and consumers, in the GB energy sector regulatory framework. This is one of the range of options that Ofgem is exploring during the ‘visionary phase’ of RPI-X@20.

At Ofgem’s workshops on RPI-X@20 in autumn 2008 it was suggested that user participation might be more feasible in transmission than distribution. For concreteness, we have been asked to consider the specific case of the forthcoming fifth electricity transmission price control review (termed TPCR5), and to provide a short report on this matter.

Section 2 of this paper explains our terms of reference and our approach to this report.

Section 3 sets out background on Ofgem’s evolving approach and its review, on traditional price control review processes and the development of stakeholder involvement, and on the issues we have been asked to address.

Section 4 indicates the types of issue that are likely to be relevant in the regulation of electricity transmission and which any revised framework would need to accommodate. To illustrate the type of coverage it looks at the approach to the price control review that was taken in the fourth transmission price control review (TPCR4) for the electricity transmission companies and discusses the types of issue that seem likely to be particularly important in any forthcoming TPCR5 review. It also describes some recent innovations and review processes that Ofgem has initiated relevant to our brief.

Section 5 provides an overview of alternative approaches we consider most relevant, then sections 6 to 9 look in turn in more detail at four particular alternatives to increasing user participation that have been used in other jurisdictions or in other markets. These are the Public Contest Method applied in the transmission sector in Argentina; the constructive engagement approach adopted in the UK by the airports regulator; negotiated settlements in parts of the US and Canada; and rules for establishing negotiated services in Australia. The section describes their main characteristics that seem relevant to the present issue. It also summarises the main points made on these models at a small discussion group of interested stakeholders facilitated by Ofgem on 26 January 2009.

Section 10 summarises our policy recommendations and sets out in broad terms some steps that Ofgem would need to consider taking if it wished to increase the scope for user participation in TPCR5.

## 2. Terms of reference and our approach

Ofgem explained to us that, as part of its work on RPI-X@20 which is at a relatively early stage, it was exploring a variety of potential enhancements to the conduct of periodic price reviews. In this wider context it was keen to draw on international experience and experience in other relevant sectors and the lessons that this might bring for GB energy regulation. It wanted to explore the experience of other countries and other UK regulators in engaging customers in the regulatory process. It wanted to look in more detail at how the experience and lessons in these areas might translate specifically into GB energy regulation. Ofgem asked us to provide a paper that would look at this issue.

In discussion with Ofgem, we decided that it would be helpful to explore the different approaches in the context of a specific future price control review. The next electricity transmission price control review seemed the most appropriate. The last transmission price review was implemented on 1 April 2007 and runs until 31 March 2012.<sup>1</sup> Ofgem has said that further substantial changes arising from the RPI-X@20 review are not to be implemented before the conclusion of the current distribution price control review (DPCR5) in March 2010. However, if the necessary further research and discussion can be completed in time, there would seem to be scope to apply alternative approaches in TPCR5, at least insofar as they do not require changes to legislation. Our report therefore includes some exploration of the possible implications for the timetable of the next electricity transmission review.

We (and Ofgem) are aware that Ofgem's duty is to protect the interests of consumers (current and future), rather than network users per se. At this stage we have looked specifically at the potential role for network users given their direct interface with the transmission licensees. In places we touch on the question of how consumer participation might be encouraged and facilitated, and what form this participation might take, but further work is needed to consider this fully.

To help in the writing of this report we have:

- reviewed the experience of alternative approaches to utility regulation in other markets and identified four models to examine further;
- summarised the salient characteristics of these approaches and how they operate;
- with Ofgem's involvement convened a small group with invited industry stakeholders to discuss the merits of these approaches and their possible implications for GB transmission regulation; and
- shared our emerging conclusions with these stakeholders.

To facilitate the small group discussion, Ofgem invited National Grid, the Association of Electricity Producers (to reflect the interests of larger conventional generators), RWE npower (as a renewable generator), CE Electric (a distributor or DNO), the Energy Intensive Users Group (reflecting larger users), the Federation of Small Businesses (to reflect the interests of non-domestic consumers), and

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<sup>1</sup> There is a separate process for setting the System Operator (SO) price control, which is coincident, but which we do not address specifically here.

Consumer Focus (representing domestic customers). In the event, not all were able to attend, but all invitees have seen this paper in draft and had the opportunity to respond.

Those present assisted in reviewing the main implications of relevant international experience, testing our thinking and helping to identify how any alternative arrangements might work in the GB energy sector. The discussion served valuably to focus thinking on the more promising themes and the issues needing to be addressed.

Details of participants in the discussion group and other invited parties are shown at Appendix A.

### 3. Background

This section sets out some further background on user participation in Ofgem's regulatory decision-making process and Ofgem's evolving policy and review on such issues.

#### *a. Greater stakeholder involvement*

Amongst other things, Ofgem has aimed to achieve wider stakeholder engagement in recent regulatory decisions. This has manifested itself in a number of areas, including:

- i. a major review of industry codes governance and rule change processes<sup>2</sup>, which is presently underway, to address the efficacy of current arrangements but which is also considering how to achieve wider stakeholder participation in industry processes;

The code governance review, in particular a consultation on the role of code administrators<sup>3</sup>, has canvassed views on improving participation of smaller participants and consumers across industry code governance processes.

- ii. preparations for the next generation of network price controls;

Ofgem recently asked electricity distributors to engage constructively with stakeholders, especially consumers, in developing their proposals for DPCR5. This review is presently underway and new controls are due to be implemented from April 2010. In initiating the review, Ofgem said:

“As part of DPCR5, each distributor will be encouraged to seek comments from regional stakeholders on its high level business plan before submitting its forecasts to us. Ofgem is also considering how to obtain the views of a cross-section of customers throughout the price review process.”<sup>4</sup>

Fuller extracts from the initial consultation are at Appendix B.

- iii. initiatives based around the Consumer First project.

In March 2007 Ofgem launched its Consumer First initiative—a programme which Ofgem says is designed “to improve the regulator's understanding of issues that matter to consumers”. Part of Consumer First involves research to inform key policy decisions. It also entails the dissemination of consumer insights across the organisation and is intended to make Ofgem's consultations more consumer-focussed and consumer-friendly.

The programme expanded in October 2008 to include a Consumer First Panel, which consists of 100 domestic customers recruited from five locations across Great Britain. The panel meets at least three

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<sup>2</sup> That review is examining the governance of industry codes such as the Balancing and Settlement Code and the Connection and Use of System Code and how such governance can be improved. The scope of the year was announced in June 2008 and the terms of reference are [here](#).

<sup>3</sup> [Code governance review—Consultation on role of code administrators](#)

<sup>4</sup> [DPCR5—Initial consultation document](#), Ofgem, March 2008

times a year to discuss key issues impacting on their participation in the energy market, as well as other key issues related to energy. To complement the work of the panel, Ofgem has also established a Consumer Challenge Group to give informed insight into high-level policy decisions. The Challenge Group consists of six consumer experts who provide Ofgem with detailed consumer insights and comments on regulatory policy decisions.

*b. Ofgem's RPI-X@20 project*

RPI-X regulation has gradually developed as a technique in setting regulated network price controls. Methodologies have evolved and institutional arrangements have been modified to address new challenges. This has happened both in the UK and overseas. UK regulators in particular have explored the scope for further improvement.

In initiating Ofgem's RPI-X @20 project<sup>5</sup> Alistair Buchanan highlighted the achievements of the RPI-X approach. But he also emphasised:

“By way of assurance I want to immediately flag up a key tenet of Ofgem's thinking [on the project]: consultation and involvement of interested parties is paramount.”

He went on to comment:

“Leading regulatory thinkers ... have been advocating quite different approaches to regulation recently. They have probed whether consumer advocate, public contest, easier settlement models are the next step for GB”.

“Ofgem is always willing to listen and take on good ideas from other regulators. For example, should we try to adopt more of the CAA's constructive engagement model...?”

Buchanan then explained that examining such approaches would be a central part of the RPI-X @20 project.

Ofgem has provided some updates on the project. In the Autumn Ofgem held a number of workshops, with industry and academics. The idea of increased user participation was discussed at these and there were a range of opinions on the merits of the approach. Details of discussions at these workshops can be found on the Ofgem website.

Most recently, in its issues paper published in late February 2009<sup>6</sup>, Ofgem indicated it considers that RPI-X continues to serve customers well, but challenges are emerging that means it is necessary to consider whether the existing regulatory framework remains fit for purpose. It noted concerns about the complexity of the current approach, and how this could be deterring stakeholder engagement. It saw the current approach as reactive to developments in government policy. Regulated companies are tending to focus on the regulator rather than on their customers, with the emphasis on how to “beat” the regulatory contract. Ofgem envisaged more focus on the need for capital expenditure, its efficiency and it's financing.

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<sup>5</sup> “Ofgem's RPI-X@20 Project”, Alistair [Buchanan, speech at SGBI, 6 March 2008](#).

<sup>6</sup> RPI-X@20: Principles, process and issues, Ofgem, February 2009), especially pp 19-22.

*c. SO incentives and the role of grid users*

Independently of the DPCR5 and RPI-X@20 processes, Ofgem has been pursuing enhancements to one area of transmission regulation, namely the setting of the SO incentive scheme. These enhancements have been designed to place greater emphasis on dialogue between National Grid (as the GB SO) and grid users.

Commenting on the changes introduced to the SO negotiation framework in 2007, Ofgem said:

“The respective role of all stakeholders will need to be somewhat different to the usual process if this experiment is to be successful. National Grid needs to go much further in explaining and communicating the options it is offering to customers and to take responsibility for securing as much engagement in the process as possible. Customers and industry participants should then be able and willing to provide more feedback and input than usual. Meanwhile, Ofgem’s role becomes more that of a facilitator to help ensure as far as it can that the engagement is effective and leads to new insights. However, Ofgem is in no sense stepping back from the process as a whole and will review the success of this innovation in determining next steps.”<sup>7</sup>

Further detail on the reworked process is at Appendix C. This process is of interest as an example of an initiative designed to increase the role of grid users in the development of regulatory proposals that impact on consumer charges. The users in this context are the parties that pay balancing charges, which represent about half the level of charges recovered under the corresponding transmission price control, so this is a significant initiative.

*d. Price control reviews and customer preferences*

In UK utility regulation, the consultation process for the periodic setting of network companies’ prices and revenues includes the provision of information by companies and an intensive regulatory analysis and discussion of this. On the basis of this interchange and wider consultation on the information and issues that arise, the regulator publishes proposals that centre on a revised price control licence condition that the regulated company must either accept or reject. If the company rejects the proposed settlement, the regulator has the right to appeal the matter to the Competition Commission.

Over time the dialogue has become longer and deeper and increasingly reliant on specialist analysis by external experts. However at its core the process has focussed on the development of proposed revenue benchmarks for the main areas of each company’s operations based on a specified regulatory asset value and an allowed cost of capital. This approach is sometimes called the “building block” methodology.

This regulatory process has developed significantly since the initial electricity price controls were set in England and Wales in 1990. In the most recent reviews, particularly DPCR5, Ofgem has increased the focus on gaining a better understanding of consumers’ needs. This has been pursued through market research, which is now an integral feature of many Ofgem processes, and increased

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<sup>7</sup> [SO incentives 2009 process letter](#), Ofgem, May 2008.

engagement with consumer representatives. Ofgem has reinforced this input into regulatory policy formation and decisions by the Consumer First initiative process referenced above.

Other regulators have used similar methods to better understand customers' needs, particularly where it is not feasible for competition to allow customers to express their preferences directly, and to incentivise service providers to discover and meet those preferences.

Another example is Ofwat's use of consumer research and cost-benefit analysis, which is summarised at Appendix D, along with the initiative developed by the Consumer Council for Water (CCWater) to engage interested parties in more active regional partnership.

## 4. Current issues in transmission regulation

Transmission regulation covers a wide range of issues, some of which have already been indicated above. We focus here on the conventional electricity transmission price control review, but this review is just part of broader set of regulatory issues (for example including SO incentives and matters covered in the Transmission Access Review). This section notes the approach taken in electricity transmission price control reviews to date, the main specific issues covered in TPCR4 and some indication of the broader range of issues likely to surface in TPCR5.

### *a. Transmission regulation to date*

In Britain revenue caps continue to apply to the transmission companies. Successive price controls were set for the electricity transmission business of National Grid in England and Wales in 1990, 1993, 1997, 2001<sup>8</sup> and 2007<sup>9</sup>. The building block approach described briefly above has remained central. Nevertheless, the processes and details of the transmission reviews have often reflected ideas and experience with the immediately preceding distribution reviews, and indeed conversely. Over time, differences between transmission and distribution regulation have emerged. For example, recent transmission reviews have had to deal with requirements for significantly increased load-related expenditure, resulting in a reopener (TIRG, see below) and introduction of revenue drivers. There have also been urgent issues relating to transmission access, which are being considered separately in the current TAR (again see below). In addition, given the lack of comparators, efficiency assumptions for transmission companies have been applied based primarily on historic performance rather than any formal econometric benchmarking process. Different approaches have also been applied to the setting of volume drivers.

In general the price control review process has become longer, the calculation of the underlying building blocks in the revenue calculation has become more complex, and a richer variety of incentive mechanisms, caps and collars and other features has been employed.

Important innovations were also introduced in 2007 by introducing concurrent reviews for electricity transmission in both England and Wales and Scotland and also for GB gas transmission.

### *b. TPCR4*

The timeline and process for TPCR4 is shown at Appendix E. The price control review process lasted roughly 18 months from the initial consultation in July 2005 through to the acceptance of Ofgem's proposals by the transmission companies in early January 2007. There then followed a period of three months in the case of the electricity companies<sup>10</sup> to develop the revised licence conditions necessary to implement the new price control proposals.

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<sup>8</sup> The control was set for five years but subsequently extended for a year.

<sup>9</sup> Settlement dates are for electricity in England and Wales. Until 2007, the two Scottish companies pursued a separate process to different timescales. Gas transmission was also subject to different work-streams.

<sup>10</sup> TPCR4 also covered the gas activities of National Grid, for which the drafting of the licence changes took six months, that is three months longer.

The conventional process as embodied by TPCR4 is based around the regulator raising policy issues and potential decisions for consultation. Interested parties are invited to respond along-side the transmission company or companies. However, the primary focus is on the company or companies producing projections, positions and in some cases proposals. The regulator responds and, to the extent the regulator considers it necessary to take wider views from stakeholders on the issues or options, it will then do so through its policy consultations. Supporting detail is often provided in the form of summary projections/plans and/or external consultant commentary on them. In a sense the regulator is acting on behalf of consumers and other stakeholders, but the involvement of these stakeholders is at one remove and often indirect. The regulator of course has a wide range of statutory duties, of which protection of the interests of customers is just one aspect.

A summary of key issues addressed during the last transmission price control review is at Box 1.

**Box 1 – Key issues in TPCR4**

1. Capex (levels of past spend, levels of future spend, user commitment, efficiency assumptions, including interaction with opex).
2. Opex (levels of past spend, levels of future spend, and results, efficiency assumptions, including interaction with capex).
3. Revenue drivers (form, level).
4. Cost of capital (CAPM vs. other approaches, calculation, beta and company risk, supporting values, post vs. pre-tax).
5. Price control level and profile (turning revenue benchmarks into base revenue (P0) and adjustment (X) values).
6. Capex incentives (capital efficiency, sliding scale vs. fixed incentives, safety net).
7. Other incentives (service quality, rewards as well as penalties, customer service, IFI, SF6).
8. Extent and nature of cost pass-through, “loggers” and reopeners.
9. Additional provisions for renewables (impact on capex, interaction with Transmission Investment for Renewable Generation).
10. Role of competition and contestability of transmission services.
11. Introduction of more comprehensive compliance reporting and monitoring arrangements (e.g. the Regulatory Reporting Pack).

*c. TPCR5*

TPCR5 has yet to commence, and based around a “traditional” review process it would not be expected to get underway until some time in 2010. It is likely that many of the issues that arose during the last review will recur during the next review as many of these are issues that will arise in setting a network company’s revenues, especially given increasing concerns about “rewiring Britain”. In fact many of the component areas identified at Box 1 apply equally to other transmitters and distributors, and they will provide the framework for any future energy network company.

The changing policy framework is also leading to a broadening of the issues that will be faced by the price review, including:

- how the proliferation in investment to connect low-carbon generation (much of which is remote) and reinforce the transmission system to get power to market should be dealt with. An example of this is the introduction of new mechanisms to deal with Transmission Investment for Renewable Generation (TIRG), where allowances additional to the conventional capex revenue allowances were introduced within the established price control period to take into account unforeseen demand-led renewables capital spend;
- strengthening transmission investment incentives and enabling anticipatory capex in the absence of connection agreements (termed firm user commitments) as previewed by a recent Ofgem consultation<sup>11</sup>; and
- transmission access, where a range of possible outcomes from the current Government/Ofgem review (or TAR)<sup>12</sup> could impact on the definition of user access rights to the transmission system, how they might be charged for and the level of the associated revenues that the transmission provider might earn. Related to these matters was the question of who should bear the associated costs and risks.

*d. Views of discussion group*

In the small group discussion we summarised our views on the nature of the likely TPCR process for the 2012 reset and the issues we thought might be addressed, and we invited comments on the issues that either the traditional approach or any alternative approach would need to address. Key points were:

- participants generally agreed that we had identified the key issues for TPCR4, and that these were likely to form the crux of the agenda for TPCR5. They suggested that the treatment of the pass-through of transmission costs by distribution networks might merit examination, as this impacted on the risks faced by distributors and thereby customers;
- they concurred that new issues were already “live” arising from established Government and regulatory policy initiatives. They recognised that interactions with wider government policy, driven by considerations of the environment and security of supply, meant that these issues and the interactions on transmission licensees business and consumer prices would become more complex during TPCR5; and
- they gave examples to highlight the increasing complexity and the uncertainties the changing policy environment could give rise to including the three issues—TIRG, enhanced investment incentives and TAR—highlighted above.

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<sup>11</sup> [Enhanced investment incentives, Ofgem, December 2008.](#)

<sup>12</sup> [Ofgem TAR webpage](#)

## 5. Alternative approaches

### *a. The nature of these approaches*

In his March 2008 lecture on RPI-X@20 referenced above, Alistair Buchanan referred to some “quite different approaches” that are used in some other jurisdictions, and also to the CAA’s use of constructive engagement. These approaches use different terms and involve different arrangements to the traditional price control review and settlement approach. However, they have certain features in common with each other, which stand in contrast to the typical regulatory process in the UK as described briefly above:

- they provide for a greater role for market participants, especially the network users, their consumers and consumers’ representatives;
- one consequence of this is that decisions can take more fully into account the preferences and concerns of these stakeholders; and
- there is a correspondingly different role for regulatory bodies, reduced in some respects but regulation still has an important role to play.

Before examining these different approaches in detail, we asked the small discussion group whether in general they thought that stakeholders would be sympathetic to a greater degree of participation of this kind, whether certain stakeholders were better placed to express views on some of the issues than others, and whether there were certain issues that were more conducive to such discussion and agreement than others.

Since the invited representatives of large users and smaller customers were unable to attend the discussion group, we are conscious that the views reported here are those of industry rather than consumer stakeholders. We have shown the draft report to the customer representatives, who have not indicated any dissent from the points made. Nonetheless, in choosing and implanting its approach to regulation, Ofgem will of course need to consider how best to discharge its statutory duty to protect current and future consumers.

### *b. Views of discussion group: representation*

It was obviously a matter for each individual user or customer representative body to decide on the extent and benefits of participation. However, the group felt that there was indeed scope for further participation, and there would be interest if this could be channelled into the most productive areas. For example, the present regulatory process tended to focus on schemes discussed between regulator and the transmission companies, rather than with network users or customers. There would be advantage in examining more explicitly what users of these services and their customers wanted.

There was of course a question as to who would or could represent consumers. For example, could DNOs or suppliers adequately represent customers, or could they do so with appropriate incentives? Would customer representatives be able or want to engage in these issues in the same way as grid

users? The industry participants doubted this would be the case but did not rule out arrangements for enabling or encouraging such participation. Any user participation process would need to demonstrate that customers' interests had been adequately taken into account. If there was not sufficiently explicit and effective involvement of customer representatives then there would be a correspondingly greater need for the regulator to do this, and to be seen to do so.

Our own view, as developed below, is that active participation by consumers or their representatives is likely to be important in ensuring both that 'justice is done' with respect to the customer perspective, and also that it is 'seen to be done'. We believe that customers and representative bodies at various levels are likely to be interested in participating in an approach that may enable them to have a tangible impact. They would either have, or could be given access to, the resources to enable them to participate effectively.

There was also a question who might represent the interests of Scottish renewables generators in discussions in England. This in turn raised the question whether the reviews of Scottish and English transmission companies should proceed in an integrated way, or in parallel, or separately, and how this would relate more generally to processes for greater user involvement. The arrangements would need to be clear on such issues.

*c. Views of discussion group: most promising areas for user participation*

Participants agreed that an important area for adding value would be where parties were better informed about their own preferences and the options available than the regulator was. For example, grid users could inform the development of estimates, plans and proposals in the area of setting service and quality standards (and to some extent the associated costs), and the reasonableness and cost of certain capital projects. Similarly customers could be expected to have views on the appropriateness of incentives impacting on quality of service, even though the service standards only directly impacted in the first instance on grid users. Both users and customers would in general be expected to have views on (their) willingness to pay for projects and services.

Conversely, in other areas users and their customers might have strong views but were thought less likely to have a more informed perspective than the regulator. Such areas included issues associated with cost of capital, taxation, accounting methods and capital structure. In such areas, customers and regulator might both depend critically on the input of specialist consultants.

There was a feeling that there was more prospect of agreement between users and companies on the first set of issues than on the second. For example, it seemed less likely that users and companies would agree on cost of capital and related issues. Even if they could agree, they would need to see the wider proposed settlement to understand the different choices and options they faced. In contrast, in respect of capital expenditure, it was thought possible that parties could have an informed discussion with a reasonable possibility of reaching agreement on, say, what the required capacity would be at a specified point in the future, what investments would be needed to provide that capacity, and what the associated investment cost might be.

It was noted that future needs were uncertain, and there would need to be provision for revising forecasts and capital expenditure in the light of events. This did not mean that discussion and agreements between the parties were irrelevant. On the contrary, parties could usefully discuss the appropriate nature of such provisions for revising plans. They would be particularly aware of the risk allocation aspects, and the potential impacts on prices. Ultimately, some of these issues might

need to be resolved by the regulator, but the stakeholders could contribute to an informed discussion and to designing innovative and mutually preferred provisions for dealing with uncertainty.

Interestingly, participants did not think that the evolution in the agenda from TPCR 4 to 5 would necessarily make it harder for stakeholders—or at least grid users—to engage. On the contrary it would make identification of their perspectives more important because of the impacts of these developments on them, particularly the potentially greater costs and risks they might face, and the importance of how the costs and risks were allocated.

Participants considered that an important potential area for discussion between the interested parties would be the design of the incentive schemes on transmission companies. It was important to encourage provision of the desired extent, pattern and timing of capital expenditure, and to discourage provision that was excessive or inadequate, premature or late. This was not to criticise the present incentive schemes, but they could be built upon with the greater involvement of users. This could be to the mutual advantage of transmission companies and users. As noted above, it was felt that the present regulatory process tends to focus on schemes discussed between regulator and transmission companies, rather than with grid users or customers.

#### *d. The approaches examined in this report*

Utility regulators around the world have different ways of taking account of the views of service users and end customers. In the ensuing sections we look at four examples based on international experience. They are distinctive approaches. They differ in the extent of use, but all have worked reasonably well—in some cases very well—in their own context. They are approaches with which we ourselves have some familiarity, albeit not as direct practitioners. They are also approaches that Ofgem has previously indicated as being worthy of further examination.

The four approaches are: the Public Contest Method as used in Argentina in the electricity transmission sector, the method of constructive engagement as used by the CAA in the UK, the method of negotiated settlements as used in the US and Canada for a variety of utility rate cases, and the method of negotiated services as used in Australia under the National Electricity Rules. We examine them in turn.

#### *e. Issues for Ofgem*

The subsequent sections of this report provide a description of the main processes adopted in the markets considered, together with a discussion of the pros and cons. This should help to identify how these approaches might be adapted or applied to the specific circumstances of the GB transmission sector.

In each case we have also noted certain ‘Comparative Features’ of the arrangements that might be relevant in assessing applicability in a British context, and also to aid comparison. These features are: how far the approach constitutes consultation or decision-making; coverage – that is, what is typically agreed or discussed in the process; the role of the regulator; possible implications for the legal structure in Britain; and general perceptions of the approach in the jurisdictions where it is traditionally practised.

A number of additional questions would also need to be addressed that we have not specifically covered in this report, including:

- who should be included in the user or customer involvement process;
- how should potential participants be identified and how might user or customer groups be structured;
- what issues should be covered by such involvement in the specific context of TPCR5; and how might they be prioritised;
- what legal changes if any might be needed to facilitate such involvement; what supporting guidelines might be needed; would there need to be new obligations on transmission operators to make the arrangement work;
- how should any disagreements or lack of progress be dealt with; how might new issues or a change in regulatory or policy be dealt with; and
- would the regulator need “step-in” powers in the event of disagreement or delay.

## 6. Argentine Public Contest method

In 1992 Argentina's electricity reform provided an innovative approach to transmission expansion. Major asset expansions were determined by the Public Contest method—that is, by votes of transmission users rather than by the transmission company or the regulatory body. Then, if approved by users, the construction, operation and maintenance of the expansion projects were put out to competitive tender.

Some distinctive features of the arrangements are summarised in Box 2. More detailed descriptions of the Public Contest method can be found elsewhere.<sup>13</sup> Our focus here is on the scope for applying such an approach in the GB transmission sector.

The Argentine arrangement has the great merit of giving grid users a direct involvement in determining capital expenditure plans. This applies to specific schemes (perhaps high profile but not necessarily) of benefit to a specific user or a sub-set of users. The approach has also been adapted to encompass the capex programme for a sub-transmission network as a whole for a period of ten years. There is evidence that many users have effectively worked together to implement such projects and plans.

There is also value in securing user commitment to funding infrastructure assets. However, such a situation is at least in part dealt with in the British situation (at least for transmission) through ‘final sums’ arrangements whereby users guarantee usage payments for a multiple of years, though these arrangements are under review as part of TAR.

The Argentine approach was designed to meet a specific need at a particular time. There was a need to put a completely new transmission regulatory framework in place. There was considerable distrust of the transmission company and of regulation, particularly in a context where the attitudes of unknown new private owners were uncertain and where utility regulation as envisaged by the privatisation programme was hitherto non-existent.

These are not generally held to be the conditions obtaining in GB at present. There are already in place an existing regulatory framework, a regulatory body and a privatised transmission company. These are all known quantities that have operated reasonably effectively over some twenty years, and that have all evolved over time in the face of changing needs. This is not to say that any of these are now perfect. But it does mean that the benchmark is different from that in Argentina. The question in GB is whether it is necessary and appropriate largely to replace the present framework of transmission regulation, or whether improvements can be secured by less far-reaching methods.

To implement the full Argentine Public Contest Method in GB, it would seem necessary to change the statutory powers and duties of the GB regulator. For example, in Argentina there is no power for the regulator and the transmission company to agree (even after an appropriate consultation process) a particular new investment programme and its associated price control. This would mean considerably reducing the present GB regulatory powers. This in turn would mean that those

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<sup>13</sup> See Littlechild S C “Symposium on electricity reform in Argentina: Preface”, *Energy Economics*, 30 (2008), 1279-1283, and numerous articles in the same Symposium volume, including “Transmission Expansion in Argentina 1: the origins of policy” (Stephen Littlechild and Carlos J Skerk) *Energy Economics* 30(4) July 2008, 1367-1384. “Transmission Expansion in Argentina 4: a review of performance” (Stephen Littlechild and Carlos J Skerk) *Energy Economics* 30(4) July 2008, 1462-1490. “Transmission Expansion in Argentina 5: the Regional Electricity Forum of Buenos Aires province” (Stephen Littlechild and Eduardo A Ponzano), *Energy Economics* 30(4) July 2008, 1491-1526.

interests presently represented and protected by the regulator would be less well represented in future.

**Box 2—Highlights of Argentine Public Contest method**

1. Applies only to new transmission investment – existing investment is covered by conventional RPI-X building block approach.
2. Applies on project-by-project basis rather than for a five year investment programme
3. However, users of the sub-transmission network in Buenos Aires Province (mainly about 200 distribution companies and cooperatives) have drawn up a ten year Transmission Investment Plan in conjunction with the relevant transmission companies, and are submitting projects under this Plan to the Public Contest Method as and when appropriate and financially feasible.
4. Decisions made almost entirely by users, not by regulator or by the transmission company.
5. Applies only to investments over a specified minimum value (US\$2m in national EHV network, \$1m in HV sub-transmission network).
6. There is an obligation on a transmission company to provide relevant technical and other information.
7. Later provisions allow greater role for the transmission company and regulator in proposing and approving and deciding upon certain investments (especially for security etc).
8. A mechanism is specified in the Electricity Act (based on the so-called “area of influence method”) for identifying the relevant voters and calculating their votes for each proposed investment. This calculation is performed by the System Operator (which is distinct from the transmission company in Argentina).
9. In simple terms, a user is a ‘beneficiary’ of a new line (or other investment) – and hence a voter - if the construction of that line would lead to increased flow from that generating station or to that distribution company or large directly-connected consumer. The number of votes of each user depends on a simulation model assessing the voter’s actual usage of the new line over the first two years of its operation.
10. A project needs the support of at least 30% of the voters for that project in order to be put up for consideration.
11. Each project that secures sufficient support (70% of the votes for that project) is put out to tender to build, operate and maintain. The term of repayment is specified by the users (max 15 years for large projects, as short as 1 or 2 years for small projects).
12. The winning bid price determines the rates that users pay for this project over the term of its life.
13. The transmission company is allowed to bid for the contract.
14. In practice, and depending on the type of investment, non-transco bidders often focus on construction, and agree with the transmission company terms for the operation and maintenance of the project.

A number of other important questions would need to be addressed about how such a model might be adapted to a British environment. For example, GB has a higher percentage of infrastructure assets in a more heavily meshed system than in Argentina. There would probably be boundary issues, especially with regard to existing/brown-field sites owing to the shared interface between in

some cases multiple generators and the transmission asset owners. A method would need to be established for determining the votes of different users. With the more meshed transmission system in GB, the Area of Influence method (as used in Argentina) could be more difficult or less appropriate to apply. Further, and more crucially, it is by no means clear how such an approach would square with the evolving approach based on firm user principles envisaged under the existing British rule-book and how it is likely to be developed under TAR.

### **Box 3—Comparative features of Argentine Public Contest method**

**Consultation or decision** – the method results in a binding decision on the participants that regulator must accept.

**Coverage** – relatively limited scope, applying to design and timing of transmission expansion programme, plus the cost and rates to be paid by users of the relevant assets that are constructed as a result of these decisions.

**Role of regulator** – the regulator implements the voting process on whether to approve proposed individual projects and the tender process according to the prescribed rules. The System Operator applies the area of influence method in order to calculate votes.

**Legal structure** – would require limits to be placed on the GB regulator’s powers, thereby changing the methods traditionally applied in price control reviews to deal with new investment.

**Stakeholder views** – many users (and the Argentine regulator too) were initially sceptical or opposed the arrangements. Over time the Public Contest method has been increasingly accepted and considered to be effective, including as a result of various modifications (e.g. to enable greater involvement of the transmission company in security-related investments). However, alternative approaches have also been introduced to facilitate greater involvement of the federal government in determining major transmission investments of a more political nature.

Consideration would be needed in allocating costs in the predominantly shallow charging methodology that is in place in GB. The Argentine method takes account of potential future users of an expansion, who would pay in proportion to usage on the same basis as the initial proponents of the expansion. However, if new investments especially in remote parts of the network are deemed to be shallow, then only part of the associated costs are presently chargeable to the user(s) requesting the investments. The method might therefore have to identify representatives of all other existing users that would have to pay the remaining part of the cost.

The competitive tendering aspect of the Public Contest method could serve to contain costs and to keep schemes to within budgeted or agreed costs. In general, competitive tendering could be used independently of the Public Contest method

A question was raised in the discussion group, as to whether, especially given the credit crunch, there would be sufficient bidders in the UK to operate an effective competitive tender. However, sufficient bidders emerged in Argentina, despite often difficult economic conditions there. And competitive bidding is being contemplated for the GB offshore transmission sector (e.g. OFTOs), though the new arrangement is not to be switched on until 2010.

Moreover, there already exists scope for contestability in new asset provision in Britain in other ways, especially at lower voltages with Independent Connection Providers. Independent DNOs are already established (though much less so in electricity than gas). Asset adoption is also an established practice here, with licensees taking on ownership of assets once commissioned. Further,

National Grid has taken steps to increase customer choice over connection charging and over construction of the assets. And the company has indicated that its policy is already to put the construction of significant new investments out to tender .

A view expressed in the discussion group is that the Argentine model could be of relevance on the periphery of the GB system, but would be less appropriate for investments that were more central to the complex GB network as a whole.

The Public Contest method, as applied to electricity transmission investment in Argentina, could help to ensure that the future investment programme does not go beyond what users are willing to pay for, and putting expansion projects out to tender should help to ensure lower cost construction, and in these respects could be relevant in particular situations (e.g. on the periphery of the GB transmission network). However adoption of this approach would need a change in the statutory framework in GB, could present difficulties in defining a new set of rules for determining the votes of each transmission user, and could involve a limitation in the powers of the regulator that could be unacceptable in GB.

#### **Box 4—Conclusions on Argentine Public Contest method**

The Public Contest method could help to ensure that the interests of users and customers who pay the cost of transmission expansion are effectively represented, and that the size or cost of the future investment programme does not exceed what these users and customers are willing to pay for.

Against this, it would seem difficult to justify the extensive legislative changes necessary to replace the present GB regulatory responsibility by something akin to the Argentine Public Contest method. There might also be some reluctance to limit the role of regulation as severely as pertains in Argentina. And it might not be straightforward to apply the Public Contest method in the more meshed and complex GB transmission system, especially against the background of current charging structures and access rules as developed and applied in GB.

The Argentine model is nonetheless interesting, and may be of relevance in particular situations, including investment on the periphery of the network for remote, spur assets. If Ofgem considered it appropriate, it would seem possible for Ofgem to indicate that it would implement an approach along the lines of the Public Contest method on the network periphery.

On balance the Public Contest method does not seem the obvious or most fruitful direction to explore further with respect to the GB transmission price control review as a whole.

## 7. CAA constructive engagement method

### a. CAA's proposed approach

Traditionally, the CAA took a building-block approach to its airport price control reviews, based on the conventional dialogue and consultation process. However, in the light of concerns about the previous airport price control review, the CAA reviewed the approach previously adopted. In May 2004 it initiated formal public consultation about a revised approach, which it discussed with airports and airlines.<sup>14</sup> On the basis of this, the CAA adopted a modified approach to revenue setting for British airports for the most recent airport price control review, covering price controls to be implemented in April 2008.

The regulator said that it would

“to the greatest extent possible base the review on direct engagement/negotiation between airports and airlines”.<sup>15</sup>

To this end, the CAA identified the main elements in the traditional building block approach, and proposed three ways of dealing with these. Certain of the elements would be the responsibility of the airlines and airports to discuss and agree, other elements would be the joint responsibility of the CAA and certain of the parties, and a third set of elements would be the responsibility of the CAA. To ensure participants had an incentive to engage in the process, the CAA committed itself to recognising their efforts, while continuing to discharge its statutory responsibilities. In simple terms, it said:

... “as long as the negotiation processes meet the CAA’s objectives in respect of the interests of future users, and passengers ... agreements would be adopted by the CAA in setting the next price control.”<sup>16</sup>

The new process—known as constructive engagement—was underpinned by supporting detail setting out the CAA’s expectations for the process of negotiation, its scope and timing. An important feature was the allocation of work between the participants in general terms:

- airlines and BAA would seek to agree traffic forecasts, quality of service standards and capex programmes;<sup>17</sup>

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<sup>14</sup> Civil Aviation Authority, Airport Regulation: Looking to the future, learning from the past, May 2004. Civil Aviation Authority. Airport regulation: the process for constructive engagement, May 2005.

<sup>15</sup> Airport Regulation: the process for constructive engagement – Industry Seminar 16 June 2005, presentation by CAA (Nick Fincham and Simon Oates), slide 10, at [www.caa.co.uk/docs/5/ergdocs/erg\\_ercp\\_airportpresentation\\_june05.pdf](http://www.caa.co.uk/docs/5/ergdocs/erg_ercp_airportpresentation_june05.pdf).

<sup>16</sup> CAA Presentation 2005.

<sup>17</sup> The initial allocation of responsibilities was as follows:

- volume and capacity requirements;
- the nature and level of service outputs;
- opportunities for operating cost efficiencies;
- the nature and scale of the investment programme;
- the efficient level of future capital expenditure associated with that programme;
- the revenues from non-regulated charges by the airport to airlines over the price control period; and

- joint work would include opex and benchmarking; and
- CAA would retain responsibility for cost of capital, scope and form of price control (P0 and X), incentives and financing issues.

The CAA set out at some length its thinking on how constructive engagement should be implemented. In particular, it made provision for monitoring the progress of the constructive engagement process, particularly by requiring feedback from the parties. This was intended to provide the CAA with assurance that the process was likely to lead to results. In the event that the process did not look likely to lead to results, the CAA reserved the right to resort to a more conventional price control process.<sup>18</sup>

In this way, the CAA hoped that the “normal business of commercial airport/airline interaction should be reinforced by the regulatory process, rather than interrupted by it.”<sup>19</sup>

Further detail is at Box 5, and more exposition of the approach can be found in CAA documents referenced above.

**Box 5—Highlights of CAA constructive engagement method**

1. The provisions for the price control review and for regulator (the CAA) to propose and determine revised price control licence provisions remain broadly as in the past.
2. Regulator (CAA) proposes at the beginning of the review a subset of issues (inputs to the price control calculation) which it would encourage the parties (in this case airport and airlines as users) to discuss and where possible agree.
3. Regulator proposes that work on another set of issues be undertaken jointly by airport, users and regulator, led by the regulator.
4. Regulator proposes that remaining work be the responsibility of the regulator. All aspects subject to normal consultation process.
5. In the case of airports, the CAA proposed that users and BAA seek to agree traffic forecasts, quality of service standards and capex programmes. Joint work would include opex and benchmarking. CAA would retain responsibility for cost of capital, scope and form of control (P0 and X), incentives and financing issues.
6. CAA indicated that it would accept agreements reached, subject to protecting interests of parties not at the table (future airlines and consumers).
7. Failure to agree would result in the process defaulting to the traditional price control process.

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— the elements of service quality and investment to which specific financial incentives should be attached and the details of such financial incentives. In practice, the issues that the airports and airlines engaged upon evolved somewhat over time.

<sup>18</sup> Airport regulation: the process for constructive engagement, CAA, May 2005, p. 7.

<sup>19</sup> CAA Presentation 2005.

*b. The outcome*

In the event, the CAA considered that the outcome was generally satisfactory at Heathrow and Gatwick, though it did not succeed at Stansted. Several broad agreements were reached. There was also an improvement in consultation and regulatory discourse.<sup>20</sup>

Varying views were expressed about the process. The Competition Commission (CC) provided a useful summary of them<sup>21</sup>, and these are summarised at Appendix F.

Briefly, three airlines (bmi, easyjet and Virgin) were not supportive. Easyjet subsequently took the CAA to judicial review over the final decision on the price cap, though not specifically citing the constructive engagement process.<sup>22</sup> But other airlines were generally supportive. Indeed, the Heathrow Airline Operators Committee (AOC) said it proved to be “a great success”, and Star Alliance said it was “merely a success”. BAA and most airlines made qualifying remarks about certain deficiencies of the process and suggestions how it could be improved.

The CC explored with CAA the concerns put to it, and expressed its own reservations and criticisms, not least about BAA’s own planning procedures. It was particularly concerned about significant increases in BAA’s capex programme during its inquiry, about information and resource asymmetries, and the absence of a dispute resolution or arbitration procedure at each stage. Nevertheless, the CC saw substantial merits in the constructive engagement process and noted that the airlines did too. The CC concluded that “Constructive Engagement has provided a useful platform for consultation and ... should be continued throughout Q5”. It made a number of suggestions for improving the process, as set out in Appendix G.

Other commentators have expressed views on constructive engagement. For example, former BAA executive Mike Toms has been critical of this approach.<sup>23</sup> However, he accepts that constructive engagement may be a necessary part of the regulatory process, and that both sides “should be encouraged to go the extra mile”. The CAA did in fact address one of his main concerns.<sup>24</sup> Moreover, it was precisely one of the difficulties of his preferred alternative - a regulator carrying out long run planning - that led the CAA to adopt the constructive engagement route.

Interestingly, when the CC was subsequently required to pronounce on the price control for Stansted airport, it considered that there was merit in reviving the constructive engagement process,

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<sup>20</sup> Bush, Harry, *Some Issues in Airport Regulation*, presentation at Hertford Seminars in Regulation, 11 May 2007.

<sup>21</sup> <sup>21</sup> Competition Commission, *BAA Ltd Heathrow and Gatwick Quinquennial Review*, Final Report 3 October 2007, Appendix D.

<sup>22</sup> The grounds cited by easyjet were giving insufficient weight to the CC’s recommendations on price levels, accepting an ‘eleventh-hour’ operating cost submission from BAA, and incorporating bonus payments for BAA’s service levels despite the CC’s finding that they were not justified.

[http://www.easyjet.com/en/News/claim\\_for\\_judicial\\_review\\_against\\_caa.html](http://www.easyjet.com/en/News/claim_for_judicial_review_against_caa.html).

<sup>23</sup> He argues that the parties are unlikely to reach agreement and that it would not be a good thing if they did, because the interests of passengers and future airlines are not represented at the table. He calls for the CAA to “develop its own analytical tools to evaluate capex programmes. ... decide what parameters define an optimal outcome, and to establish methodologies for calibration of proposals against these parameters”. He recommends cost-benefit analysis as required by Ofwat. Toms, Mike “Airports regulation: a case of destructive engagement?” Beesley Lectures on Regulation, Series XVIII, London, 9 October 2008.

<sup>24</sup> To better reflect the interests of passengers (who were not at the table), the CAA introduced a positive incentive for BAA to improve quality of service, beyond what the airlines considered necessary for their own purposes. This is one of the CAA’s actions that easyjet is arguing against.

which achieved “some considerable progress”.<sup>25</sup> Admittedly, the task was less challenging than before, because it was now possible to defer the largest and most controversial element of the capex programme until the next five year period.<sup>26</sup> But the CC’s actions and comments suggest that it now saw constructive engagement as more than just a ‘platform for consultation’. Rather, it became an integral part of the decision-making progress on future development at the airport.

#### **Box 6—Comparative features of CAA Constructive Engagement approach**

**Consultation or decision** – the method results in advice to the regulator, which is not legally binding, but which the regulator commits to incorporating into its decision unless there are reasons not to.

**Coverage** – the scope is flexible, and to date has focused on traffic forecasts, quality of service and capex; in principle it could be varied according to circumstances.

**Role of regulator** – the regulator proposes topics for parties to negotiate, reserving other aspects of the traditional price control process to itself. It also acts in a fall-back capacity in the event of non-agreement, with a default to the traditional regulatory process.

**Legal structure** – no changes would be needed to permit implementation in the British system, though the regulator would need to develop process guidelines.

**Stakeholder views** – initial scepticism among the participants in the UK airline sector gave way to largely favourable support (but not unanimously and not unqualified) from participants. The Competition Commission was initially somewhat critical but later found it helpful to use the process at Stansted, and has proposed its continuing use.

It is worth noting that the CC explicitly took account of the interests of parties not at the table, and it considered that these were adequately represented by parties that were there.<sup>27</sup> It also made further recommendations to address complaints about BAA’s conduct since 2002.<sup>28</sup>

In the light of the CC’s recommendations, the CAA is presently in the process of implementing a framework for constructive engagement in the future.<sup>29</sup> It is also using a similar approach in the NATS price control review that is now getting underway.

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<sup>25</sup> “We took the view that the airport’s airline customers are generally in a much better position than the regulator, the CAA, to suggest what development is needed at the airport, even recognising that these interests might, on occasion, diverge from the interests of future airlines and passengers, whose interests should also be represented. Therefore, we sought to rekindle the process of constructive engagement between the airport and the existing airlines and, through these discussions, we saw some considerable progress.” Competition Commission, Stansted Airport Ltd, Q5 price control review, 23 October 2008b, para 23, p. 8.

<sup>26</sup> BAA submitted a largely agreed and much reduced £90m capex programme for developing existing facilities (reduced from £239m). It proposed only £40m of initial expenditure on a second runway and terminal, deferring consideration of the proposed full cost (£1.2bn) until the next price control period.

<sup>27</sup> “We considered whether the interests of potential new airlines at the airport or passengers might deviate from the interests of current airlines in these decisions, but we found no reason to believe that they did.” (CC 2008b) para 24. p.8.

<sup>28</sup> The CC found that there had been “significant failings in the consultation process, and that the information provided by BAA to the SACC [Stansted Airline Consultative Committee] had been insufficient and untimely to enable effective consultation”. This was against the public interest. The CC recommended that CAA remedy the adverse effects in two ways: (i) the information provided as the basis of consultation should be improved, provided on a more timely basis, and should address the needs of users, and (ii) a facilitator should be appointed to encourage an efficient process of consultation and to ensure compliance by BAA to the obligations imposed on it by the CAA following this finding.” (CC 2008b) para 29, pp. 9, 10.

<sup>29</sup> See for example the proposals concerning the provision of information and the process of consultation in Airport Regulation: Economic Regulation of Stansted Airport 2009-2014, CAA Decision, 13 March 2009, section 6.

How far the regulator should get involved in dispute resolution is worth further consideration, and may vary from case to case.<sup>30</sup> However, the remedies being developed by the CC and CAA could lay the basis for more effective and more extensive use of the constructive engagement process in future. Indeed, there is a case for extending constructive engagement to include the level of charges or revenue implied by the agreed investment programme, as is normally the case with negotiated settlements.<sup>31</sup>

### *c. Evaluation*

The CAA's constructive engagement approach seems to offer the prospect of fruitful discussion on a number of elements of the transmission price control review, without committing the parties to attempt agreement on all elements. More specifically, those elements identified in the discussion with grid users (see section 4 above) as conducive to bilateral discussion and agreement correspond broadly to those elements where the CAA invited the airports and airlines to participate in constructive engagement; and those elements where small group participants thought agreement would be difficult were those that the CAA reserved to itself.

There are of course a number of differences between the airport and electricity sectors that make direct read-across not straight-forward. For example, it was suggested in the small discussion group that there is more scope for differentiated service both between airports and between airlines than there is in the case of electricity transmission, though some variation of standards can be applied in connection terms and the associated security standard. Common service issues are more narrowly defined in airlines than in transmission. It was also suggested that incentive structures in energy were more sophisticated and targeted than in the case of airports, but at the same time local capacity decisions were probably more difficult to determine in the case of airports. It was said that connection arrangements in the electricity sector already allowed customers to exercise choice over connection and security levels, but there were limits on the scope for choice given the homogenous nature of the electricity product.

These differences do not, in our view, detract from the merits of the basic constructive engagement approach. Greater dialogue between service provider and service user, and in particular the ability for service users to make known, discuss and agree service requirements (and how different choices and options interact) and have them explicitly translated into cost estimates, is likely to produce a better outcome for customers in most circumstances than a regulator can identify.

Despite the advantages, there have clearly been some difficulties with constructive engagement, particularly in the initial attempt at Stansted airport. However, it does not seem to have been alleged

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<sup>30</sup> The CAA emphasised that “if it were to have been drawn into individual disputes, during the process of negotiation, its involvement would have undermined that process and risked unravelling a complex set of compromises and agreements.” Competition Commission, BAA airports Market Investigation, Provisional Findings Report, 20 August 2008a para 7.30 In the US and Canadian jurisdictions where negotiated settlements work well, it does not seem to be considered helpful for the regulator to ‘monitor what is going on’ and act as arbitrator. A recent view in Australia said that “Though introduction of an airport-specific arbitration mechanism would be counterproductive, the parties should be expected to negotiate and resolve disputes within an appropriate commercial framework, and to be assessed accordingly under the new over-sighting arrangements.” Productivity Commission, *Review of Price Regulation of Airports Services*, Inquiry Report No. 40, 14 December 2006, p. xii.

<sup>31</sup> The CAA has proposed a similar approach to the setting of National Air Traffic Services, which does not specify any limitation on what the parties might agree. NATS (En Route) plc, Price Control Review for Control Period 3, 2011-2015, CAA Consultation, October 2008 ch.5.

that the participants have actually been put at a disadvantage, compared to what the conventional approach has delivered. Indeed, the CAA has commented in subsequent presentations that nothing is lost, and potentially much is gained, by at least proposing and attempting constructive engagement. The CC has identified a number of deficiencies in the initial CAA process, and scope for improvement in future. These relate, in particular, to the provision of adequate information by BAA. The CAA has recently addressed these issues at Stansted.

Electricity and other regulated sectors can learn from the CAA's experience. For example, to make constructive engagement work in transmission, it would be necessary for the regulated transmission companies to provide sufficient information on specified issues in a timely way in order to facilitate informed discussion and agreement. Issues of confidentiality would also need to be dealt with. Ofgem would need to satisfy itself that all relevant topics were being dealt with. It would need to consider whether the main users of transmission services adequately reflected all the interests involved—not least those of final customers—and the public interest with respect to for instance environmental considerations. If not, Ofgem would need to consider how best to ensure that all relevant parties were at the negotiating table and that these considerations were adequately reflected in making its final price control decisions.

We take up these issues again in the final section of this report.

#### **Box 7—Conclusions on CAA Constructive Engagement approach**

The approach of constructive engagement as developed by the CAA seems relatively well-suited to the UK energy regulatory approach. It could build on present practice applied by Ofgem, and has an element of regulatory discretion in how far industry parties are invited to discuss and agree particular issues. It is therefore possible to focus discussion on the more promising areas and leave the more difficult areas to existing regulatory practice. There is also scope for the regulator to take into account public interest considerations that may go beyond the interests of those represented at the negotiating table (although to give undue weight to this could reduce the advantages of the approach).

There is a danger that a regulator might prescribe an inappropriate (or too broad or too narrow) set of issues for the parties to engage in. However, this could be minimised if the regulator takes full account of the preferences and perceptions of the parties, and allows for some flexibility in the evolution of the approach over time. In this way, constructive engagement could secure the potential advantages of negotiated settlements within the context of the now-traditional GB price control approach.

These remarks are true of transmission regulation in particular, even though conditions and issues are obviously somewhat different from those in airports. The approach would therefore need to be adapted to electricity and gas transmission.

Constructive engagement is not without its difficulties and critics. However, the CC and CAA have given considerable thought to how those difficulties and criticisms may be overcome, and are taking steps to address the issues. Ofgem would be able to learn from this experience.

Importantly, if the constructive engagement approach were to commend itself as part of the current policy development work, then more work would be needed by Ofgem and interested parties on the specification and precise application of this approach.

## 8. US and Canadian negotiated settlement approach

Negotiated settlement methods have been applied in various different contexts in North America.<sup>32</sup> We have referred to three instances as part of our work: all have taken place in the context of the traditional regulatory approach there. This context is a process of litigation in which the regulatory commission can determine a hearing, and the regulated utility can request a hearing, whenever either feels that the allowed rates (or tariffs or prices) are no longer ‘just and reasonable’. The utility and other interested parties provide evidence on costs and other relevant matters, which is subject to cross-examination in the regulatory ‘court’. In the light of this the regulatory commission determines rates that will apply until a further application and rehearing. In simple terms, the approach assumes a ‘building block’ approach, in which allowed rates are expected to cover efficient operating costs plus a reasonable rate of return on capital in a ‘test year’. Traditionally, the test year was in the recent past; nowadays it may be in the future; but there is typically less explicit consideration of future business plans than in GB. This process of litigation takes effect unless the interested parties agree some alternative approach that the regulatory commission approves in lieu of a hearing and decision.

### a. *Example 1*

In the 1960s, US federal energy regulators (FPC then FERC) saw negotiation between the parties as a solution to the increasing backlog in pipeline rate cases, and encouraged the parties to settle. For example, from 1994 to 2000, 39 out of 41 gas pipeline rate cases were wholly or partially settled by such negotiation.<sup>33</sup>

### b. *Example 2*

Individual states encouraged settlements to different extents. In Florida the regulatory commission was very supportive. A major role was played by the Office of Public Counsel (OPC), as the representative of residential and other customers. In coordination with various other users and consumer groups, it has negotiated many settlements with telecoms, gas and electricity utilities.<sup>34</sup> Over the last 25 years, these settlements have delivered three quarters of the achieved utility rate reductions—actually 90 per cent excluding the impact of tax reductions and one exceptional case. One electricity base rate settlement was for \$350 million (£230 million) per year for three years. In total the settlements amounted to nearly \$4 billion (£2.7 billion) in the electricity sector alone.

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<sup>32</sup> Doucet, Joseph and Littlechild, Stephen, “Negotiated settlements: The development of legal and economic thinking”, *Utilities Policy*, 14(4), December 2006a.

<sup>33</sup> Wang, Z, “Settling Utility Rate Cases: An Alternative Ratemaking Procedure,” *Journal of Regulatory Economics* 26(2) September 2004: 141-164

<sup>34</sup> Littlechild S C, “Stipulations, the consumer advocate and utility regulation in Florida.” *Journal of Regulatory Economics* 35 (1) 2009a, 96-109. (Earlier and fuller version available as Electricity Policy Research Group Working Paper No. EPRG 06/15, 25 February 2006, Cambridge: University of Cambridge, at <http://www.electricitypolicy.org.uk/pubs/index.html>).

Littlechild S C “The bird in hand: stipulated settlements and electricity regulation in Florida.” *Utilities Policy* 2009b (forthcoming). (Earlier and fuller version available as Electricity Policy Research Group Working Paper No. EPRG 07/05, February 2007, Cambridge: University of Cambridge, at <http://www.electricitypolicy.org.uk/pubs/index.html>).

c. *Example 3*

In Canada major pipelines increasingly settled with their users, partly to avoid lengthy legal hearings but also to achieve results that were beyond the reach of litigation. Settlements came to be struck typically for between three and five years.<sup>35</sup> Such multi-year settlements included:

- features based around tailored incentives;
- innovative provisions to improve quality of service;
- agreed terms for pipeline expansions;
- agreements on the provision of information and arrangements for monitoring; and
- agreed remedial actions in some instances where performance had been inadequate.

Some of these settlements are now in their third settlement period, and are now a feature of the Canadian oil and gas regulatory landscape. They focus on the issues and outcomes that the parties themselves find most important. Most are full settlements, dealing with all the issues of concern, but in some cases the parties may agree a partial settlement to some of the issues, leaving others to be decided by the regulatory commission.

Many of the benefits in Florida and Canada derived from replacing traditional rate of return regulation by RPI-X type incentive price caps for specified periods of years, an approach that has worked well in the UK. The resulting efficiency improvements have yielded significant price reductions along with higher profits.

But that is not all that was achieved. In general, the settlements have better reflected the actual preferences of the customers and the companies, unconstrained by the formal regulatory process. The settlements have also been characterised by flexibility, variety, a wide scope, innovation and learning, as some legal scholars have noted. Importantly, and particularly in Canada, the process has significantly improved mutual understanding and company-customer relationships in these utility sectors.

The legal and regulatory context in North America is different from that in the UK. In North America traditional cost of service based regulation puts emphasis on litigation and case law at rate hearings. The inflexibilities of this approach seem to have been a significant factor driving utilities and other participants to find more flexible outcomes via negotiated settlements. In this way they have been able to look at the overall package rather than fight over each item of the rate settlement on a line-by-line basis.

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<sup>35</sup> Doucet, J and Littlechild S C, “Negotiated settlements and the National Energy Board in Canada”, Electricity Policy Research Group Working Papers, No. EPRG 06/29, November 2006b. Cambridge: University of Cambridge at <http://www.electricitypolicy.org.uk/pubs/index.html>. (A shorter and more accessible version is now available on the Ofgem website)

This was a point made during the session with the small discussion group. Negotiated settlements provide flexibility in the North American context against the background of a more rigid regulatory tradition. However, many of the advantages of such settlements were already built into the British system through the regulatory flexibility developed over periodic price reviews, and in particular through the continued emphasis over a number of past price reviews on performance incentives.

**Box 8—Highlights of North American negotiated settlements**

1. There is a specified and long-standing regulatory litigation process in North America to determine utility rates (including for electricity) and other service parameters. This process applies in absence of any agreed settlement, or to the extent that any agreement cannot be reached.
2. This traditional rate setting process is often considered to be overly legalistic, expensive and time-consuming. It may be based on annual cycles (particularly in Canada) where the regulator has been reluctant to approve rates for the indefinite future. It is usually cost-based and (until recently) has not typically addressed incentives. It is the antithesis of ‘performance-based regulation’ (PBR) such as RPI-X where rate setting is carried out periodically and incorporates explicit incentive mechanisms, and which was developed specifically to move away from of the perceived ‘pass-through’ of costs associated with the traditional process.
3. It is up to the parties—essentially the utility as the service provider and service users—what to negotiate and when to do so. Typically they do so as any existing agreement or rate decision is coming to the end of its term.
4. The regulators in some jurisdictions have encouraged the parties to negotiate and settle; others jurisdictions have discouraged this.
5. In the event of a negotiated settlement, the regulators in some jurisdictions have typically accepted the settlement without modifying it (that is, there is no cherry-picking). In other jurisdictions the regulators have accepted some elements and not others, which has not been conducive to further settlements.
6. Occasionally the regulator has suggested modified provisions to deal with parties not at the table (including possible future competitors).
7. In Canada the federal energy regulator (the National Energy Board or NEB) has set out guidelines to facilitate settlements. These include a willingness to judge a settlement by the reasonableness of the process rather than imposing its own views on outcome.
8. The NEB has also specified a formula for cost of capital that it will apply in the absence of settlement. In practice the parties have mostly either used that value or agreed a slightly higher value in return for enhanced service provision.
9. In the absence of unanimity amongst interested parties, different regulators have different procedures, some more explicit, others not so well-specified.

As with constructive engagement, there is a question whether all interests will be adequately represented at the negotiating table. Some argue that consumers, particularly smaller consumers, will lose out as a result of settlements negotiated between utilities and larger consumers (although evidence from Florida suggests that smaller users have gained from the process). Others are concerned about a lack of transparency if issues are no longer litigated before the regulatory commission.

A failure to agree unanimously does not invalidate the settlement process. As Wang explains, at least one regulator (FERC) has developed guidelines and practices for dealing with contested settlements that do not necessitate abandoning the settlement and starting again with the traditional regulated approach.

In North America consumer engagement in the process is often encouraged, but there is no standard approach. In Florida there is an official consumer representative. In some other jurisdictions interested parties including consumer representatives can be funded by the regulatory process, thereby facilitating their engagement. This is the case in parts of Canada, where costs can be recovered from the utilities as part of the litigated price control or the negotiated settlement. Would consumer representatives be willing and able to participate in GB? In our view, they would be willing, provided there was an ability to ‘make a difference’. A regulatory framework that explicitly encouraged negotiated settlements and/or constructive engagement would offer this. They would also be able to participate, either by virtue of their own resources, or as a result of funding provided as part of the regulatory process. It would be possible to make provision for covering the costs of consumer representatives, as in North America, and to ensure that they had access to relevant information.

#### **Box 9—Comparative features of North American negotiated settlements**

**Consultation or decision** – the outcomes established by the parties are subject to acceptance by the regulator, which is usually forthcoming (at least in the case of uncontested settlements).

**Coverage** – typically the process concentrates on prices and tariff structures for the service in question, but the process can also include investment plans, quality of service, incentive mechanisms and other issues of mutual interest.

**Role of regulator** – the regulator appraises any settlement put forward against its statutory duties. It also acts as a fall-back in the event of non-settlement, contested settlement or partial settlement.

**Legal structure** – a negotiated settlements approach could be accommodated within the current framework, though guidelines and procedures could be needed to establish a supporting process framework.

**Stakeholder views** – there are mixed views in North America, with opposition in some US markets but support in others. There seems to have been a more positive response in Canada.

The negotiated settlement approach allows the parties to negotiate all or most of the items at issue. However, it is possible to agree a partial settlement that leaves to the regulator some difficult issues, for example, the cost of capital or overall price level. As noted earlier, the small group participants questioned whether agreement on such issues would be achievable in the UK context. In Canada, the National Energy Board as regulator has decided to set default values for the cost of capital in the event of failure to agree a settlement on this aspect. This approach seems to have been effective in Canada (although one cost of capital case is presently under challenge and the NEB is expected to pronounce on it shortly). The small discussion group participants were surprised that it was considered possible to determine the cost of capital before determining what the likely risks (and opportunities) to the utility would be, which would depend on the nature of the price control as a whole (including the risk and incentive arrangements in it). There was therefore a question in their minds whether it would be appropriate in GB to set the cost of capital in advance of other elements of a settlement.

### **Box 10—Conclusions on North American negotiated settlements approach**

Negotiated settlements in the North American context provide greater flexibility than the more rigid regulatory tradition there. The parties have used such settlements as a way of introducing mutually beneficial innovations, notably incentive-based price controls. Many of the advantages of the North American approach have already been achieved in the British system through the inherently greater regulatory flexibility in GB, which has developed over periodic price reviews, notably in the emphasis on performance incentives. However, the preferences of users and consumers are taken into account more explicitly in settlements in North America.

The adoption of such an approach could enable utilities and users to negotiate and agree features of a price control that were of particular significance to them (such as capital expenditure programmes, service quality provisions and incentive arrangements). There is clearly benefit in achieving wider stakeholder agreement on key customer-facing elements of the regulatory settlement.

It is an open question whether such agreement could be achieved with respect to final decisions on all issues, particularly those involving cost of capital and other key risk-allocation issues. But in practice partial negotiated settlements are sometimes agreed in North America that leave unresolved issues to the regulator.

A negotiated settlement approach would not preclude the parties from discussing and seeking agreement on all issues of interest to them. However, in the GB context it would seem possible to secure the main prospective benefits of the negotiated settlements approach by the more structured route of constructive engagement. In either case, it would be necessary to consider how best to incorporate the interests of those not at the negotiating table, including wider public interest issues and how to address appropriate government concerns.

## 9. Australian negotiated services

The concept of negotiated services is a relatively recent one within the Australian national electricity rules.<sup>36</sup> The approach was introduced to replace an ad hoc and unsystematic approach to “excluded services” whereby separate jurisdictional regulators<sup>37</sup> administered them differently.

The Australian arrangements apply to individual services or to a subset of services offered by the regulated entity, and cover both electricity transmission and distribution services.<sup>38</sup> The arrangements do not apply to the regulated services as a whole or even to the main regulated business.<sup>39</sup> The intention is that bespoke arrangements can be established to better match the preferences of consumers where consumers wish to express such preferences.

As yet there are not many instances of these provisions being applied, though that may well reflect their recent introduction. Many of the regulated companies still have to adopt the various compliance statements and guidelines required by the new rules. The scope for application is, however, significant, as augmentation (that is, capital investment) schemes above a certain threshold for transmission would fall under the definition of negotiated services. They would therefore be subject to the negotiating framework that the rules provide must be established by each network service provider.

Such services are similarly defined in the UK but the licence treatment is relatively high-level. Licence conditions define how such services can be identified and then stipulate that they should be subject to reasonable rate of return criteria.<sup>40</sup> Historically, their scope has been limited in this country other than for connection assets.<sup>41</sup>

Despite the different terminology and the differences between the UK and Australian regimes, there are on closer examination also several similarities. A range of services already falls outside direct price/revenue control in the UK, and network owners ordinarily offer choice in connection and other services through non-standard offers and choice over connection design. Independent connection providers are also well-established in the market. The interim regime for “connect and manage” being implemented by National Grid in the UK at present, together with recent changes to transmission charging methods, also mean that the scope for bespoke solutions in transmission is set to increase in terms of service level options.

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<sup>36</sup> Chapter 6A of the Australian National Electricity Rules deals with the economic regulation of transmission services. The rules, currently version 25, are [here](#). Section 6A.9 deals with negotiated transmission services.

<sup>37</sup> Until 2005 the Australian states and territories applied state-based regulation for distribution companies. The arrangements are currently transitioning to a single federal rule book set by a single body and administered by another. A similar process was adopted from 1996 with regard to transmission.

<sup>38</sup> Excluded services are regulated services that are remunerated outside of the price control because they have unpredictable costs or where there are specifically identified beneficiaries.

<sup>39</sup> There are transitional rules in the Australian national rules for some states that allow for some services to be shifted from the directly controlled services (those subject to the RPI-X price control) so they are dealt with under the regulatory rules that determine pricing arrangement for the negotiated services).

<sup>40</sup> Excluded services are provided for at Part A of Schedule A to the Transmission Licence.

<sup>41</sup> In distribution all connection assets fall outside of the price control; for transmission pre vesting connection assets are within the price control, post vesting connection assets are outside.

### **Box 11—Highlights of Australian negotiated services approach**

1. Significant change is afoot in Australia because of regulatory consolidation and rationalisation and industry concerns about a lack of regulatory certainty and consistency.
2. The process for dealing with negotiated services is hard-wired into the rules.
3. For distributors there is scope to apply these rules to excluded services and metering services (which are still part of the regulated distribution business).
4. There is greater scope for application to transmission, with the rules specifying coverage of:
  - connection services including entry, exit and TNSP to TNSP connection services;
  - use of system services supplied by the shared transmission network that exceed or are below the networks specified performance standard under any legislation of a participating jurisdiction; and
  - use of system services relating to augmentation or extension for loads of the transmission network.
5. The regulator is required under the rules to define the criteria for identifying negotiated services.
6. Regulatory rules also set out the principles for determining terms and prices
7. The regulated utility must set out in compliance statements:
  - its negotiating framework
  - the criteria it will apply in treating such services as negotiated services.
8. The regulator determines any disputes involving distributors.
9. A commercial arbitrator determines disputes involving transmission service providers.

There are different conventions with regard to codification between the two jurisdictions, for instance in terms of the level of specification of the obligations on the service provider and the compliance arrangements in place, with the Australian rules generally tending to be very prescriptive. However the principles applied through licences/rules have common features, including broad criteria for defining such services. Both regimes contemplate a role for the regulator in the event of referral of any dispute, though one important difference is the express provision in Australia for disagreements over transmission services to be referred to a commercial arbitrator.

Participants in the small discussion group seminar noted that the scope for bilateral negotiation of services that has to be provided under the Australian National Electricity Rules is similar to the scope that already exists within the British system under the network licences. Such an approach therefore would not of itself significantly extend the extent of user participation in the British price control review. On the other hand, the codification of practice might provide some pointers to more formal rules of engagement in a British setting, if that were to seem desirable.

### **Box 12—Comparative features of Australian negotiated services approach**

**Consultation or decision** –the process aims to facilitate agreement between the parties (i.e. a decision), though disagreement can lead to arbitration.

**Coverage** – the arrangement has limited coverage applying to non-common services. However the transmission rules contemplate application to new transmission investments above a defined threshold.

**Role of regulator** – the regulator sets out negotiating parameters. In the case of a dispute over negotiated distribution (but not transmission) service, the regulator is also the arbitrator.

**Legal structure** – such an arrangement could be accommodated within the current GB framework (and already operates informally with regard to excluded services), though guidelines and procedures could be needed to establish a more explicit process framework to mirror the Australian approach.

**Stakeholder views** – the arrangements are relatively new and there is no assessment available on the application of the rules.

The regime is relatively new, and to date there is no written material on actual experience of its application as far as we are aware.

### **Box 13—Conclusions on Australian negotiated services approach**

The Australian negotiated services approach is intended to facilitate discussion and agreement for certain services, especially where services have some bespoke element or where different service levels might be feasible.

In general the scope for bilateral negotiation of services that has to be provided under the Australian National Electricity Rules is similar to the scope that already exists within the GB system under the corresponding licences. In the absence of evidence suggesting that GB procedures discourage negotiations, there seems no obvious advantage in adding the level of prescription associated with the regulation of these services adopted in Australia. Moreover, such an approach would not of itself significantly extend the extent of user or customer participation in the GB price control review.

Overall, Australian experience may be seen as a continuation of developments in bespoke services and allowing non-standard offers rather than a step-change or shift in the regulatory regime or price control processes. The GB regulatory regime seems to be evolving anyway in a direction that permits such outcomes.

## 10. Conclusions and implications for Ofgem

### *a. Conclusions*

The main conclusions we draw from our assessment and the limited discussions to date are as follows:

- in some respects increased user and consumer involvement are already being incorporated in electricity regulation in Britain, for example through:
  - the Consumer First initiative—a programme of research and engagement commenced in March 2007, which Ofgem says it has designed to improve its “understanding of the issues that matter to consumers”;
  - an instruction to distributors to engage a wider group of stakeholders in the development of their business plans and forecasts for the distribution price control review presently underway (DPCR5);
  - refashioning the annual system operator (SO) incentive setting process so that the initial stages are conducted between the licensee and grid users;
- there is scope further to increase the involvement of network users and consumers in price control reviews generally, and in the forthcoming transmission price control review in particular;
- all four of the approaches we have considered have potential benefits, and points of direct or potential relevance to GB policy and more specifically to the RPI-X@20 review. They also have certain difficulties or limitations with regard to their transposition into the GB regulatory framework;
- we would highlight the following headline points from the comparison:
  - the Public Contest method could help to ensure that the future investment programme does not go beyond what users are willing to pay for, and putting expansion projects out to tender could help to ensure lower cost construction, and in these respects could be relevant in particular situations (e.g. on the periphery of the GB transmission network). However adoption of this approach would need a change in the statutory framework in GB, could present difficulties in defining a new set of rules for determining the votes of each transmission user, and could involve a limitation in the powers of the regulator that could be unacceptable in GB;
  - constructive engagement has not been without difficulties in the UK airports sector but agreement has been reached on significant elements of airport price controls, lessons have been learned and a more robust regulatory framework is being put in place. The approach is flexible and able to focus on those issues where constructive discussion and agreement seem most likely (provided the regulator’s specification is not unduly restrictive), leaving to the regulator those issues where agreement seems less likely. It would not need any change in the GB statutory framework;

- negotiated settlements would enable utilities and users to negotiate and agree features of a price control that were of particular significance to them (such as capital expenditure programmes, service quality provisions and incentive arrangements). Using such an approach might set an unduly high hurdle to overcome if it is expected to deliver agreement on the whole range of issues to be covered by a future price control, but that would be equally true of constructive engagement, and in practice partial negotiated settlements are sometimes agreed that leave unresolved issues (such as the cost of capital) to the regulator. It would be necessary to ensure that the interests of all parties, including Government departments where appropriate, were adequately taken into account in the negotiations; and
  - the Australian negotiated services approach is intended to facilitate discussion and agreement for certain services, especially where services have some bespoke element or where different service levels might be feasible. In this context some elements of the approach are already applied in GB through existing rules for excluded services albeit on a more limited basis. However it would not seem significantly to extend the role of users or customers in the process of resetting price controls per se, and the same limitation would apply if the same practices were adopted in the UK;
- at this stage the most promising prospect for further exploration, at least in the context of a periodic GB transmission price control review, would seem to be an approach based on constructive engagement. Provided that it is applied with sensitivity to the preferences and aspirations of the parties, it could achieve the potential benefits of the negotiated settlements approach within the context of the GB regulatory framework and could add significantly to the present extent of user participation there;
  - this approach would need to be suitably modified to reflect the particular conditions of the energy sector and TPCR5; and
  - more research is required as to how such an arrangement could and should be developed and applied.

### *b. Implications for Ofgem*

Even though it would not involve any change to the statutory framework, any shift to a constructive engagement approach would require certain changes to the way Ofgem leads the periodic regulatory review and to Ofgem's own conduct. For example, in order to implement constructive engagement for TPCR5, Ofgem would need to indicate clearly its commitment to such an approach and to set out the main elements of the process involved.

Specifically Ofgem would need to:

- provide greater clarity on its intended role and the roles of participants with respect to the reorganised review process;
- begin the consultation process sufficiently early to enable greater industry and consumer participation, including in scrutinising the transmission companies' business plans;
- indicate those issues on which it would particularly welcome constructive engagement between the transmission companies and their users (which might be similar but not identical to those issues indicated by the CAA, taking into account the initial views of the potential participants

and without being unduly restrictive as to the issues on which discussion and agreement might be invited);

- consider whether the participating stakeholders adequately represent the interests for which Ofgem has responsibility and, if not, take steps either to ensure adequate representation or to communicate to the parties Ofgem's views on the interests of such parties;
- put in place analogous procedural provisions to those proposed by the Competition Commission for the airport sector, and presently in the course of implementation by the CAA;
- request the transmission companies to establish appropriate discussions with key stakeholders, including grid users and consumer representatives, where the latter should reflect smaller as well as large users. Ofgem could usefully give thought to encouraging the formation of a user group to participate in the process;
- specify a time-frame over which negotiations should take place, which might include deadlines for particular decisions so as to enable Ofgem to take forward the other aspects of the review consistent with the overall price control review timetable;
- indicate any conditions that would need to be satisfied by the constructive agreement process, including with respect to reflecting and protecting the interests of parties not at the table (including government departments); and
- specify how it would proceed in the event that such a constructive engagement process failed to make the hoped for progress and/or where agreement might not be reached.

Ofgem would also need to:

- require the transmission licensees to provide the information necessary to facilitate informed discussion on these matters, including that needed for each licensee to develop and publish in a timely manner a suitably detailed business plan in advance of negotiations; and
- in doing this also encourage the transmission operators to make relevant additional data available where reasonably possible.

These steps would not of course preclude Ofgem from continuing to explore and implement other types of consumer engagement, either in the price control review or in other regulatory activities.

## Appendix A: Small Discussion Group participants

To facilitate the small group discussion, Ofgem invited Paul Whittaker (National Grid), Laura Schmidt (the Association of Electricity Producers, to reflect the interests of larger conventional generators), Charles Ruffell (RWE npower, as a renewable generator), Phil Jones (CE Electric, a distributor), Jeremy Nicholson (the Energy Intensive Users Group, reflecting larger users), John Holbrow (the Federation of Small Businesses, to reflect the interests of non-domestic consumers), and Katharine Morrison (Consumer Focus, representing domestic customers).

The meeting was held on 26 January. Paul Whittaker, Laura Schmidt and Phil Jones attended, along with the present authors and representatives of Ofgem. Our draft report including an account of the meeting was circulated to all those invited. We have since been able to discuss the issues set out in this paper with Katharine Morrison and Jeremy Nicholson, though they have not made any formal response. None of the representatives has indicated any views contrary to those provided at the meeting.

## Appendix B: Extracts from DPCR4 initial consultation (March 2008)

“Increased consultation with local stakeholders and a willingness from DNO management to think creatively about their business plans is essential if we are to move towards more sustainable networks and to meet the specific objectives related to the environment, customers and security of supply”.

“We see DPCR5 as the first step in developing stakeholder engagement and would expect the experience gained as part of this review to inform the RPI-X@20 review when it assesses alternatives such as making more use of constructive engagement during price control reviews.”

“There may be opportunities to develop, extend and improve customer service arrangements to reflect changes in performance and address worst served customers in particular, and to encourage DNOs to consider the standard of their interaction with customers and stakeholders more generally.

In formulating their business plans, we expect DNOs to engage with local stakeholders and to demonstrate how these views have impacted on their plans.

We will look to address this in DPCR5 by giving DNOs more opportunity to come forward with forecasts based on their own business strategies that take into account the needs and aspirations of their local stakeholders.”

### **“Stakeholder engagement**

4.43. In DPCR4, we developed the IQI to place more weight on company forecasts. We plan, where possible, to develop this further to allow us to place more emphasis on DNO forecasts for DPCR5. To increase Ofgem’s confidence in the robustness of their forecasts, DNOs will need to consult more widely on their plans, provide greater visibility of their assumptions and justify their forecasts based on the outputs they will deliver.

4.44. In practice, this will require DNOs to engage more widely with their stakeholders in developing their plans. Much of our work on developing the commercial regulatory framework since DPCR4 has involved encouraging the DNOs to engage more with their stakeholders. Some progress has been made, although we are keen to develop this further in DPCR5.

4.45. We do not want to prescribe how DNOs should go about engaging with stakeholders but are keen to use this price control review as a way of identifying effective methods of engagement and the issues stakeholders are most responsive to. As a minimum, we expect DNOs to:

- identify stakeholder groups and the issues on which they want to engage each group;
- make available their plans in a user friendly format,
- present stakeholders with a range of investment options including both high and low cost sensitivities as well as their base case expenditure and identify any tradeoffs both in terms of costs and outputs in order for stakeholders to make informed contributions possibly via regional consultations or workshops,

- engage with users or potential users of the networks (including those looking to invest in distributed generation, new demand or demand side management) to better understand future requirements for network capacity, and
- engage with input manufacturers and contractors to understand any delivery issues and how this may impact on their plans.

4.46. We do not expect the DNOs to duplicate the research Ofgem is currently undertaking as part of the consumer first project in relation to consumer willingness to pay.

4.47. It is important that DNOs are able to show how stakeholder views have impacted their plan in a quantified way. This should include any changes to assumptions, impact on investment options and changes to the level of outputs delivered.

4.48. When considering stakeholder views it is important that DNOs are still able to show the benefits to customers as a whole and that the plan still reflects the DNO's best view in making the trade off between different stakeholders who may have conflicting views.

4.49. Ofgem recognises that some aspects of DNOs' plans might be more suitable for stakeholder engagement than others, such as the level of incremental investment that should be targeted at specific outputs (e.g. how much investment should the DNO make to increase flood protection or improve environmental performance relative to existing levels).

4.50. We see DPCR5 as the first step in developing stakeholder engagement and would expect the experience gained as part of this review to inform the RPI at 20 review when it assesses alternatives such as making more use of constructive engagement during price control reviews.

4.51. We have already met with a number of DNOs to discuss their approach to stakeholder engagement for DCPR5 and are encouraged by the approaches and strategies that have been discussed. We would welcome further discussions with DNOs or interested stakeholders.”

## Appendix C: SO incentives 2009-10

Independently of the DPCR5 and RPI-X@20 processes, Ofgem has been pursuing enhancements to one area of transmission regulation, namely the setting of the SO incentive scheme. These innovations have been designed to place much greater emphasis on dialogue between National Grid as the GB SO and grid users (though not specifically consumers and their representatives). The costs of the incentive scheme are recovered in the first instance by generators and suppliers equally (and ultimately of course by consumers), so they are considered to have the most direct interest in the terms of any revised scheme.

Regulation of the SO (as opposed to the Transmission Owner) is now determined as a bespoke process. In 2001 a revised regime was implemented for electricity under which the direct (or internal) costs of the SO became subject to a free-standing five year RPI-X price control<sup>42</sup>, while the indirect (or external) costs were subject to an annually set split savings regulatory control in the form of an incentive scheme. Under this mechanism a target was set in advance for the costs of the scheme in the subsequent year, and any variation was allocated between the company (through an incentive payment) and consumers (through pass through) according to defined proportions negotiated by the regulator and the company. In short, if the SO beat the target (incurred a lesser level of costs), it got to keep a share of the savings; if it exceeded the target (spent more than the target), it had to meet a share of the over-run. The arrangement was also subject to a series of caps and floors which, as with the sharing mechanism, have varied annually.

In 2007 Ofgem initiated a review<sup>43</sup> of these arrangements as part of a wider review of SO activities, and following stakeholder feedback and support the arrangements were changed for the year 2008-09. In a letter in October 2007<sup>44</sup>, Ofgem said:

“In previous years, National Grid has provided its forecasts for the costs that it will incur in its roles as gas and electricity SO. Ofgem has then scrutinised these forecasts and published its Initial Proposals consultation document for incentive schemes based on the information provided to it by National Grid. Based on the responses received to this consultation, Ofgem has then produced Final Proposals (including licence modifications) by the end of February, for implementation on 1 April.”

It continued:

“This year [i.e. for 2008-09], instead of Ofgem taking the lead at the Initial Proposals stage, we have requested that National Grid provides and consults upon its own set of proposals. This means that in early December Ofgem will publish simply a cover letter together with National Grid’s proposals. This letter will make clear that we do not endorse the proposals that are tabled. But we will encourage both National Grid and interested parties to debate and discuss the proposals tabled by National Grid, based on a consultation framework led by National Grid, and facilitated by Ofgem. National Grid should be better-placed than Ofgem

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<sup>42</sup> Previously the costs had been included as part of a single transmission price control.

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[http://www.ofgem.gov.uk/Markets/WhlMkts/EffSystemOps/SystOpIncent/Documents1/July\\_initial\\_thoughts\\_document\\_-\\_070731.pdf](http://www.ofgem.gov.uk/Markets/WhlMkts/EffSystemOps/SystOpIncent/Documents1/July_initial_thoughts_document_-_070731.pdf)

<sup>44</sup>

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=122&refer=Markets/WhlMkts/EffSystemOps/SystOpIncent>

to set out the real choices and trade-offs it has to make in efficiently operating the systems and to translate this into different options for customers. Ofgem has therefore encouraged National Grid to consider how it can present its customers with meaningful choices in terms of the sharing of risks and rewards between Grid and customers and to reflect this in the incentive scheme structures that it proposes.”

Ofgem said it would then take into account its results and provide guidance on the Final Proposals to be put forward in February, adding:

“If the new process has gone well Ofgem may be better placed than in previous years to propose and implement proposals that are good value for National Grid and for customers. If the new process has not been effective or if Ofgem has concerns that key cost and risk issues have not been addressed by stakeholders, Ofgem may choose to implement a different scheme to that proposed by National Grid.”

Looking back on the 2008-09 process Ofgem commented that the general consensus from respondents was that “the change in process had been successful”. There was a common view that:

“the change to the process had created additional transparency, further explanation of National Grid’s key assumptions and the opportunity for bilateral discussions with National Grid.”<sup>45</sup>

There was support overall for building on the process in future years. The only criticism highlighted in the Ofgem assessment of the process was that the timescales available for consideration of the options put forward by National Grid was considered very limited. Some stakeholders would have preferred earlier engagement in the development of the incentive schemes (more “thinking time”).

Ofgem concluded that:

“the change in process was generally a successful move. [It] considers that the change in process has allowed industry participants to be significantly more engaged with the debate about the proposals for the SO incentive schemes and that this was reflected in the quality of consultation responses.”

It therefore asked National Grid to begin the process of developing and consulting on initial proposals for its incentive scheme from April 2009 and set out a more detailed timetable accordingly.

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<http://www.ofgem.gov.uk/Markets/WhlMkts/EffSystemOps/SystOpIncent/Documents1/SO%20Incentives%20Open%20Letter%20May%202008.pdf>

## Appendix D: Water sector initiatives

There are two initiatives we highlight from the water sector:

- Ofwat's use of consumer research and cost-benefit analysis, which is summarised at Box A
- an initiative developed by the Consumer Council for Water (CCWater) to engage interested parties in more active regional partnership.

### **Box A—Customer research in the UK water sector**

In the present (and still on-going) price control review in the water sector (known as PR09), Ofwat has required a more structured approach to consumer research.<sup>46</sup> It required companies to carry out joint research with stakeholders into customers' views and priorities during the initial phases of the review. It then fed back comments to each company, prior to joint research with stakeholders on the companies' draft Business Plans. It took steps to determine an agreed approach, for example using a steering group with representatives of all parties involved. In addition, the official customer group Consumer Council for Water (CCWater) attaches particular importance to customer research, and each year conducts tracking research to gauge customers' views about the performance of the companies. During PR09 it has project-managed 'deliberative research' on behalf of a wide stakeholder network.

Ofwat has also put greater emphasis on cost benefit analysis in PR09, explicitly requiring that companies justify their Business Plans in these terms. This pushes companies to think more thoroughly about the costs and benefits of their proposed investments, highlights the implications of quality regulations, and provides more tangible evidence about any conflict between required standards and customer willingness-to-pay.

Experience to date suggests that this consumer research is providing better information about customer preferences and willingness-to-pay for improved services. Many companies are also doing their own research, and there is a possibility that each party might choose the results that best suit its own purposes. Similarly, cost-benefit analysis should provide a more informed basis for assessing investments and quality standards. But there are some concerns about the methodologies, applications and selective use of these analyses.<sup>47</sup>

Since research and CBA both have their limitations, regulation has also involved greater use of customer representatives in the decision-making processes. An interesting and potentially relevant development in the water sector has been the initiative of CCWater, though of course it too has pros and cons. (*see Box B*).

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<sup>46</sup> See especially *Setting price limits for 2010-15: Framework and approach – a consultation paper*, Ofwat, 18 October 2007.

<sup>47</sup> For further discussion of the water sector approaches, see, *Constructive engagement and negotiated settlements – a prospect in the England and Wales water sector?*, Stephen Littlechild 29 August 2008, available at <http://www.eprg.group.cam.ac.uk/wp-content/uploads/2008/11/negotiatedsettlementsew29aug08.pdf>

### **Box B—Regional “partnerships” in the UK water sector**

In the light of previous experience, CCWater concluded that the most effective way to bring to bear the views of customers was to try to ensure that local views and concerns were incorporated into companies’ strategic thinking and planning from the beginning, rather than to make representations at the end of the process. To this end it proposed partnership at the regional level to complement Ofwat’s national initiatives. It set up a Quadripartite Working Group for each of the 20 companies in England. Each Group comprises a representative of the water company, the Environment Agency, the Drinking Water Inspectorate and CCWater, plus in some cases Natural England. In Wales there is a single Group organised by the Welsh Assembly Government.

Each Group sets its own objectives and arrangements, e.g. “Working in partnership to actively seek, facilitate and ensure the best possible outcome from PR09 for all relevant stakeholders across the region”. The emphasis is on knowledge-sharing rather than reaching agreement.

Early experience has been encouraging. Groups provide earlier and first-hand knowledge of other parties’ views and of companies’ plans. This can reduce tensions and differences, with less need for Ofwat to resolve all issues.

Against this, the time required can be demanding. Performance is variable. Ofwat’s non-participation is sometimes questioned. Some would argue for a regional rather than company perspective.<sup>48</sup>

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<sup>48</sup> Stephen Littlechild, “Let’s make a deal ...”Utility Week, 14 November 2008, pp. 18-19. For further detail see Stephen Littlechild, “Constructive engagement and negotiated settlements – a prospect in the England and Wales water sector?”, 29 August 2008, available at <http://www.eprg.group.cam.ac.uk/wp-content/uploads/2008/11/negotiatedsettlementsew29aug08.pdf>

## Appendix E: TPCR4 time-line

July 2005	<ul style="list-style-type: none"> <li>Initial Consultation (Ref No. 172/05)</li> </ul>
December 2005	<ul style="list-style-type: none"> <li>Second Consultation (Ref No. 277/05)</li> </ul>
February 2006	<ul style="list-style-type: none"> <li>Capital Expenditure Projections 2007-2012 (open letter) (Ref No. 21/06)</li> </ul>
March 2006	<ul style="list-style-type: none"> <li>Third Consultation (Ref No. 51/06).</li> <li>Third Consultation, Appendices (Ref No. 51/06b)</li> </ul>
May 2006	<ul style="list-style-type: none"> <li>Access Reform in Electricity Transmission: Working group report and next steps (Ref No. 83/06a).</li> <li>A framework for considering reforms to how generators gain access to the GB electricity transmission system: A report by the Access Reform Options Development Group (Ref No. 83/06b).</li> </ul>
June 2006	<ul style="list-style-type: none"> <li>Initial Proposals (Ref No. 104/06).</li> <li>Initial Proposals, Main Appendices (Ref No. 104b/06).</li> <li>Initial Proposals, Appendix: Offtake Revenue Drivers and Baselines for NGG NTS (Ref No. 104c/06).</li> <li>Initial Proposals, Draft Enduring Offtake Impact Assessment (Ref No. 104d/06).</li> </ul>
September 2006	<ul style="list-style-type: none"> <li>Updated Proposals (Ref No. 170/06)</li> <li>Updated Proposals, Appendices (Ref No. 170/06a)</li> </ul>
November 2006	<ul style="list-style-type: none"> <li>Draft licence modifications (gas and electricity) (Ref No. 197/06)</li> </ul>
December 2006	<ul style="list-style-type: none"> <li>Final Proposals (Ref No. 206/06)</li> <li>Final Proposals, Appendices (Ref No. 206/06a)</li> </ul>
January 2007	<ul style="list-style-type: none"> <li>Draft licence conditions 2<sup>nd</sup> informal consultation (electricity) (Ref No. 10/07)</li> <li>Draft licence conditions 2<sup>nd</sup> informal consultation (gas) (Ref No. 16/07)</li> <li>Draft licence conditions 2<sup>nd</sup> informal consultation (gas), appendix (Ref No. 16a/07)</li> </ul>
March 2007	<ul style="list-style-type: none"> <li>Statutory consultation on licence modifications (electricity) (Ref No. 39/07)</li> </ul>
April 2007	<ul style="list-style-type: none"> <li>Draft licence conditions 3<sup>rd</sup> consultation (gas) (Ref No. 95/07)</li> <li>Draft licence conditions 3<sup>rd</sup> consultation (gas) appendices (Ref No. 95a/07)</li> </ul>
May 2007	<ul style="list-style-type: none"> <li>Draft licence conditions 3<sup>rd</sup> consultation (gas) open letter (Ref No. 117/07)</li> <li>Draft licence conditions 3<sup>rd</sup> consultation (gas) open letter (drafting) (Ref No. 117a/07)</li> </ul>
June 2007	<ul style="list-style-type: none"> <li>Statutory consultation on licence modifications (gas) (Ref No. 151/07)</li> </ul>
July 2007	<ul style="list-style-type: none"> <li>Statutory consultation on licence modifications (gas) (Ref No. 195/07)</li> </ul>
September 2007	<ul style="list-style-type: none"> <li>Decision to modify the NTS gas transporter licence.</li> </ul>

## Appendix F: Competition Commission summary of CAA constructive engagement process 2008<sup>49</sup>

52. We asked BAA and the airlines whether the Constructive Engagement process was working: BAA recognized that Constructive Engagement was in its infancy and that some improvement was needed. It accepted that it should have shared its HET proposal with the airlines earlier and said that it would now try to consult the airlines earlier in the process. The Heathrow AOC considered the Constructive Engagement process to be a great success and marked a significant improvement in BAA's consultation with the airline community. In particular, the Constructive Engagement process had allowed the airlines and BAA to create a vision for the future and had been good at reaching agreement on the path towards a level playing field in relation to various elements of the infrastructure. Star Alliance clarified that the views of the Heathrow AOC did not fully reflect its own: it considered Constructive Engagement to have merely been a success and pointed out that neither the Star Alliance nor Virgin had endorsed the final Constructive Engagement document. It added that the past 12 months had been a difficult and time consuming path, where Star Alliance has had to resign itself to things that might not provide a level playing field. BA also supported the Constructive Engagement process for its ability to provide a structured framework for dealing with BAA, a result of which had been the agreement on the occupancy strategy. However, BA also considered that the process suffered from limitations which needed to be dealt with. BA considered that Constructive Engagement was undermined where BAA failed to consult or share information with airlines. This had been the case in relation to several important inputs to the current price control review, namely project specific costs, on-costs and risk monies, capex at Heathrow (including HET, pier service and the Eastern Apron development, capex at Gatwick and non-regulated charges). BA also noted that Constructive Engagement itself could not procure implementation of agreed actions and that therefore there should be an annual review by the CAA of BAA's performance in relation to actions agreed as part of Constructive Engagement. IATA commented on the lack of transparency of the Constructive Engagement process and in particular the lack of business case in relation to HET. oneworld strongly endorsed continuing the process. bmi was concerned that future spend on Terminal 5 had been excluded from Constructive Engagement discussions. The airline had not taken part in the process, as it lacked the resources needed and did not believe that the process would deal with its main concerns: achieving smaller increases in charges and better delivery of service, with differential charging for differential facilities. easyJet commented that the Gatwick Constructive Engagement was becoming unravelled. Virgin commented that too much reliance had been put on the new process.
53. We are of the view that Constructive Engagement has provided a useful platform for consultation and that it should be continued throughout Q5. We have had, however, some concerns about certain aspects of the process and have sought the CAA's views on the following issues:
- how the Cotterill recommendations would be implemented during Q5: the CAA told us that it has invited BAA to put forward a proposal in September 2007 to expand the Annex 4 agreement, incorporating, where appropriate and relevant, Cotterill's recommendations. The CAA told us that some recommendations, however, could not readily be codified in a written statement, as they pointed to a change in emphasis and approach by BAA;
  - whether a dispute resolution mechanism should be built into the Constructive Engagement process: the CAA clarified that the Constructive Engagement process had been set up to enable the parties to work towards resolving differences without the intervention of the regulator. Looking forward, the CAA intended to establish, in its regulatory policy statement, the standards for consultation which it would expect BAA to adhere to. The CAA also told us that BAA operated and was expected to continue to operate a dispute resolution mechanism and that, in addition, any airport user might bring a case to the CAA for it to apply conditions on the airport to prevent or remedy any unreasonable discrimination on the part of the airport operator;

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<sup>49</sup> Competition Commission, *BAA Ltd Heathrow and Gatwick Quinquennial Review*, Final Report 3 October 2007, Appendix D.

- whether the significant information and resource asymmetry between BAA and the airlines allowed BAA to ‘divide and rule’: the CAA pointed to the well-established committee structures at each airport, through which airlines could share information among themselves, discuss proposals from BAA, and represent airline community views back to BAA;
- how BAA arbitrates between various airlines’ views: the CAA noted that it had not received any responses from the airlines repudiating the description, recorded in each airport’s Constructive Engagement report, of the airline positions on the capital investment plans. Referring to the letters sent by BA and the Star Alliance to BAA (described in paragraphs 84 to 87), the CAA added that it was not surprising that individual airlines would seek to promote their own commercial interests by emphasizing those aspects of, and enhancements to, the capital investment plants which they favoured;
- whether the voices of the non-aligned airlines were adequately taken into account: the CAA told us that those airlines were members of the airline consultative committees and relevant Constructive Engagement groups at each airport and that it had not received any complaints that the views of such airlines were not adequately represented;
- the extent to which BA is in a privileged position: the CAA pointed to the accelerated development of HET and refurbishment of Terminal 3 and Terminal 4 during Q5 as evidence that BAA was responding to the commercial needs of a broad range of airline users and not giving undue preference to BA;
- the consequences of bmi not taking part in the process: the CAA commented that this was a commercial decision made by bmi and that bmi was represented in the Constructive Engagement process via the Star Alliance;
- the causes of the significant increase in capex ambitions, late in the consultation process and during the Q5 regulatory review: the CAA believed that at Heathrow this was primarily due to requests by the Star Alliance and the airlines occupying Terminal 3 for additional capex in order to increase the degree of competitive equivalence across the Heathrow campus and that at Gatwick the increase in spend was the result of higher traffic forecasts;
- whether airlines have received information in a timely manner so as to be able to assess it properly: the CAA commented on the impact of the regulatory process and its arbitrary deadlines on the smoothness of the Constructive Engagement process;
- the extent to which the conclusions of Constructive Engagement are undermined by the lack of discussion of the implication of the capex options for airport charges and for operating costs: the CAA considered that the airlines had had access to a number of sources of information, from BAA and the CAA, to help them form a view on the implications of capital investment on airport charges; and
- whether the process should also involve a top-down discussion, starting with a target spend and target airport charges and the prioritization of projects within these targets: the CAA told us that this approach had been open to BAA and the airlines at each airport but that the approach actually taken was more logical. The CAA was also doubtful that the level of target spend could be set at each airport and that because of the interaction between capex and airlines’ operating costs resulted in complexities which would not be best tackled through the establishment of top-down capital budgets for each airport.

## Appendix G: Competition Commission assessment of consultation on capital expenditure<sup>50</sup>

- 4.13 As apparent from Figure 1, regulation of the BAA's designated airports is based on allowing a reasonable rate of return on the RAB, which consists of the value of past and, in any regulatory period, projected investment. A significant weakness of such an approach to regulation is that a return may be allowed on an investment irrespective of its merits: although it would be open to a regulator not to allow a return on an investment that has clearly been unnecessary, not wanted by users, or carried out at an excessive cost, it would be far from straightforward to establish that is the case, and we are unaware of any airport investment not having been included in the RAB for that reason. It is therefore important to have mechanisms to ensure that the projects carried out benefit users, have expected benefits that exceed their costs, and that the projects are not carried out at excessive costs. Effective consultation with airlines, to the extent that airlines, operating in a more competitive market, can be regarded as a proxy for their customers, is one means to ensure this.
- 4.14 In paragraph 2.424 of the 2002 report we discussed a range of complaints from airlines about consultation on capex, but concluded that given the constraints and uncertainties there was insufficient basis to establish conduct against the public interest. But we said that we would expect to see significant improvements in Q4. As noted in paragraph 49 of Appendix D, in paragraph 3.63 and Annex 4 of its Decision of February 2003 on the Economic Regulation of BAA's London Airports the CAA set out an agreement reached with BAA on enhanced information disclosure and consultation. It also indicated that it would expect in due course to review performance under these arrangements. The CAA appointed Bob Cotterill<sup>7</sup> to carry out this review. He concluded in his report published in December 2006 as part of the CAA's initial price proposals that starting from a low base prior to Q4, BAA's information disclosure and consultation had generally improved, particularly since 2005 following the CAA's Constructive Engagement initiative, but suggested that a better planned and more integrated approach to consultation should be taken. (Paragraph 50 of Appendix D summarizes the steps he recommended should be adopted.)
- 4.15 Constructive Engagement between BAA and the airlines is clearly an important process in resolving uncertainty as to the projects to be undertaken, although we recognize that certain details of the schemes will require continuing discussion as the projects develop. Agreement between BAA and the airlines is a far preferable way to decide the investment programme than relying on the judgement of ourselves or the CAA. Most of the airlines to whom we spoke also regarded Constructive Engagement as a significant improvement on previous levels of consultation, or consultation at other airports.
- 4.16 We share a number of the concerns put to us about several aspects of the process of consultation, including Constructive Engagement, but which also relate to BAA's planning of the CIP more generally, with implications for the assumed level of capex and its allowance in the RAB, and for which there is clear scope for improvement during Q5.
- 4.17 The significant increase in BAA's capex programme during the course of our inquiry which we noted in paragraph 4.8 itself suggests, in our view, weaknesses in BAA's long-term planning of capex, its proposed programme for Gatwick more than doubling, with little apparent consultation, in only a couple of months. Such a significant increase in capex ambitions late in the consultation process has resulted in decreased transparency of costing and difficulties in assessing the proposed plan as part of the CC inquiry; as a result, we are concerned whether airlines have received information in a timely manner and are able properly to assess it. It may also lead to hasty and inadequate planning of the projects concerned. Another example is the absence until a late stage of the process of a business case for HET, although we are sympathetic to bmi's argument that this should not now delay the project.

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<sup>50</sup> Competition Commission, *BAA Ltd Heathrow and Gatwick Quinquennial Review*, Final Report 3 October 2007.

We were also surprised that there appears to have been little detailed planning of the HET project until about 2005.

4.18 The significant changes to the CIPs over the last few months show that Constructive Engagement cannot be confined to the periods approaching a quinquennial review, but that it should be a continuous process, including, as suggested by Currie & Brown, effective involvement of airlines in the initial stages of considering options for projects and, as some of the airlines suggested to us, more regular and systematic consultation on any changes to the capex programme within each quinquennium.

4.19 Among our other concerns on Constructive Engagement (on which the CAA's comments are set out in Appendix D) are:

- (a) Significant information and resource asymmetry between BAA and the airlines at any time which could allow BAA to 'divide and rule'.
- (b) Inadequate information in the CIP to support the estimated project costs, with cost breakdowns provided only for one-half of the major projects, and the on-cost and risk allowances not explained.
- (c) Very limited information on the implication of the capex for operating costs. It is difficult to see how BAA's airline customers can form properly informed views on the approval of capex programmes when the cost and charging implications of these programmes on these customers are not readily apparent. (This had been noted by the Cotterill review and does not seem to have been addressed in the latest CIP.) The surprising scale of the increase in operating costs associated with the opening of Terminal 5 as currently estimated by BAA (to which we refer in paragraph 4.143(b)) shows the importance of this issue.
- (d) Little discussion of the implications of particular projects or the programme as a whole for airport charges. It is in consequence likely that each airline will want the particular projects from which it will benefit, but to which it will only pay a fairly small proportion of the cost; but not wish to pay its share of the costs of projects from which other airlines will benefit but not themselves. Even though airlines are clearly best placed to scrutinize BAA's capex plans, there is a risk that any CIP agreed through Constructive Engagement will be inflated by the airlines mixed incentives, and BAA's incentive to grow the RAB. We recommend that the selection of projects for inclusion in the CIP should be informed by a top-down discussion, starting with the overall master plan and strategic business plan for each airport, target airport charges, the implied target capital spend and the prioritization of projects within these targets.
- (e) The difficulty for airlines in judging the impact of investment on charges, or therefore in assessing the merits of individual projects or the overall programme, unless they are able to analyse the commercial revenues likely to be generated by the projects and which, under the single-till approach, would offset the effects on airport charges.
- (f) The resource-intensive nature of BAA's consultation process more generally, especially for airlines with a smaller presence at the two airports, with limited resources, few staff in London, and/or without membership of one of the alliances. There is therefore a risk that the voices of the non-aligned airlines or airlines such as bmi not taking part in the process are not sufficiently taken into account, that too much weight may be attached to the views of a small number of well-resourced airlines, and that BA in particular could be in a privileged position.
- (g) The absence of a dispute resolution/arbitration mechanism at each of the relevant stages of planning and implementation, with the CAA acting only as an observer to date, which it felt strongly should be its role unless agreement was not reached by the end of the process on any particular points.

(h) Lack of clarity in how BAA arbitrates between various airlines' views and how apparent consensus has been reached in areas which appeared to be hotly contested a short while previously (e.g. inter-terminal baggage system).

We recommend that the CAA should address the above matters in implementing the recommendations of the Cotterill report and revising Annex 4 of its Q4 decision document, and in further developing the Constructive Engagement process. BAA told us it was committed to consultation and was currently reviewing and enhancing the current Annex 4 proposal outlining the information and structure necessary to improve consultation.