

MINUTES OF THE JOINT REGULATORS' MEETING

26 JANUARY 2005

Present: Chris Bolt (PPP Arbiter and ORR) Chairman
Alistair Buchanan (OFGEM)
Alan Sutherland (WI Commissioner Scotland)
Philip Fletcher (OFWAT)
Dr Harry Bush (CAA)
Sarah Chambers (Postcomm)
Douglas McIlldoon (OFREG)
Sir John Vickers (OFT)

In attendance: Rob Toal (ORR) Secretary

Apologies: Stephen Carter (OFCOM)
Nigel Stapleton (Postcomm)

ITEM 1 Minutes of the 24 September 2004 meeting

1. The minutes of the previous meeting were accepted subject to some minor changes from ORR.

ACTION: SECRETARY

ITEM 2 Presentations on price control final conclusions

(a) Ofgem

2. Mr Buchanan described the main features of Ofgem's recent decisions on electricity distribution price controls. Mr Buchanan explained that this was the fourth such review and noted that distribution charges represent approximately 25% of electricity customers' final bills. The headline message for this review is that in the first year prices will increase by 1% and then will be set at RPI-0 for the remainder of the control period, which is equivalent to an increase of approximately 6p a month for a typical household.
3. The broad philosophy for this review remained the same, the use of comparators and incentives were important (although Ofgem moved away from relying on an efficiency frontier to setting benchmarks based on the upper quartile).
4. Allowed CAPEX increased by 48% which meant that the focus of the review had shifted from OPEX to CAPEX. The potential for large OPEX efficiencies were largely gone to the extent that companies had been set a 3% target over the five years of the control period. In terms of quality of supply, the revenue at stake

through the IIP regime has been increased to 3% of revenue. Social / Environmental issues had a higher profile in this review e.g. facilitating renewable energy through distributed generation. Companies also received a revenue allowance to carry out research activity.

5. In 1994 share prices doubled following the conclusion of the review, in 1999 they fell by 30%, this time share prices went sideways. This was the most complex of the reviews Ofgem has carried out, for example with the introduction of the sliding scale mechanism for CAPEX. The key feature of this approach is that companies are rewarded for providing accurate CAPEX forecasts.
6. All companies accepted the final conclusions which means that Ofgem/Offer has still only had one challenge to its price review conclusions (Scottish Hydro-Electric in 1996) and even that was on a technical matter.
7. Ofgem are set to initiate a number of other price reviews over the next year or so and will be going out to consultation on the appropriateness of RPI-X regulation going forward.

(b) Ofwat

8. Mr Fletcher explained that 23 water and sewerage companies were covered by the price control review and that full competition was still some way away in the water industry. The price limits set by Ofwat have a direct impact on customer's bills, the previous review had led to a reduction in bills of approximately 12%. This had a negative impact on the companies' share prices. Two of the smaller companies appealed to the Competition Commission after the last review.
9. Ofwat followed a transparent and orderly process and tried to work with other stakeholders for example in relation to carrying out customer surveys. Ofwat's focus was on encouraging less well performing companies to improve to catch up with the best –performing companies thus mimicking the effect of competition.
10. The large CAPEX programme put pressure on the balance sheet; this was due in part to the capital maintenance programme but was also impacted by environmental CAPEX. Ofwat determined the cost of capital on a post-tax basis. The differences between Ofwat and Ofgem assumptions were attributable to the different profiles of the sectors being regulated. Companies were tested against financial indicators and some of the companies needed additional revenues to meet the pressure on the balance sheet. Share prices have risen and are broadly back where they were seven years ago. Final decisions by companies on whether to accept the price limits were due shortly after the meeting.
11. Ofwat were still committed to RPI-X regulation but the review contained elements of rate of return regulation. In terms of incentives the review left some room for out-performance and included an additional incentive for exceptional performance.

Discussion

12. In response to questions, Mr Buchanan said that distribution companies had been facing a large potential pensions liability which mainly related to early retirement costs. Ofgem had decided that a 70/30 split of the liabilities between customers and shareholders would be appropriate. Ofgem published all of the

professional work they had commissioned as part of the review, although they had taken out commercially sensitive information.

13. Mr Fletcher noted that water companies had argued that they managed their pensions liabilities efficiently. Europe Economics produced a paper on pensions issues for Ofwat. Ofwat sought to place companies on a level playing field so as not to introduce disadvantages in terms of comparative regulation. Ofwat considered that 50/50 between customers and shareholders was a reasonable split.
14. In terms of information requirements, Mr Fletcher explained that Ofwat were helped by having an established set of data and because of the transparent nature of the process, Ofwat were able to demonstrate that they used all of the data they requested from companies and had effectively systematised the approach to asking for information. Ofwat accept that much of the information provided by companies is confidential. Dr Bush said that under the NATS price review, CAA expected to publish all of the reports produced by consultants.
15. Sir John Vickers noted that in both sectors, comparators were a very important part of the price control process and asked how valuable comparators remain after 15 years of regulation. Mr Fletcher said that comparators were crucial in the absence of competition.
16. Mr Buchanan noted that there were 14 electricity distribution companies but only 7 ownership groups. Mr Buchanan said that comparators for OPEX were less important for Ofgem than they had been previously but the sliding scale on CAPEX may capture comparisons in another way.

ITEM 3 Current cross regulatory issues

(a) Freedom of Information Act 2000

17. Mr Fletcher reported that Ofwat had received a request under the Freedom of Information Act 2000 from Water UK to provide minutes for each of the 2004 JRG meetings. Ofwat had also received a number of additional information requests from Water UK including a request to provide Ofwat's Board minutes.
18. Mr Fletcher would review the 2004 minutes with a view to identifying passages which are exempt and seek views of other members before responding to Water UK. Following discussion about practice in other public bodies on production of minutes it was agreed that in future JRG minutes would be published with redaction of any items where Freedom of Information exemptions apply. It was also agreed that the Secretary would compare best practice in producing minutes.

ACTION: MR FLETCHER, SECRETARY

(b) DTI/HMT project: Concurrent Competition Powers in Sectoral Regulation

19. DTI/HMT had written to all sectoral regulators and OFT to set out details of this project. Sir John Vickers noted that a parallel review of the Enterprise Act was taking place.

(c) DTI/HMT report on the drivers and consequences of increased gearing

20. This report was noted. It was agreed that in the light of the two new cross-regulatory groups established as a result of this report it would be helpful to carry out a broader review to identify all current cross-regulatory initiatives.

ACTION: SECRETARY

ITEM 4 Tour de Table

21. Mr Sutherland (**WI Commissioner Scotland**) has published details of how his office expects to carry out the next price review of Scottish Water. He is due to receive guidance from Ministers on 10 February. Scottish Water is some way behind English and Welsh water companies in terms of realising potential efficiency savings.
22. Dr Bush (**CAA**) said that CAA had published a document summarising responses to the CAA's proposed approach to airport regulation and were due to publish a further document in March setting out in more detail the rules of the game for the new approach.
23. Mr Fletcher (**Ofwat**) explained that as there was no longer a requirement for Competition Commission reports on mergers to be referred to the Secretary of State, there was increased merger speculation in the water sector. Consumer bodies have been critical of Ofwat's policy on mergers. There had been an example of whistle-blowing where an ex-employee of Severn Trent Water had made an allegation that the company distorted figures on bad debt to improve its regulatory position. Ofwat is currently considering this issue. Glas Cymru has said that it will pay a rebate to customers.
24. Ms Chambers (**Postcomm**) reported full market opening of the postal market was set to take place from 1 January 2006 and a document setting out details of this will be published shortly. The initial proposals for the next Royal Mail price control will be published in May 2005.
25. Mr McIlldoon (**Ofreg**) reported that two new combined cycle gas turbine power plants were due to come on-line in Northern Ireland. Work was ongoing to construct a single Irish energy market, with a single pool intended to be in place by 2007, Ofreg would be looking to understand how the trading arrangements operate between Great Britain and France.
26. Mr Buchanan (**Ofgem**) said that fuel prices were a big issue: prices had peaked in October last year but have now fallen. Ofgem was continuing its review of gas wholesale prices. DG COMP is also looking at both gas and electricity markets. BETTA is still on target for go live on 1 April 2005. Ofgem are seeking to bring the timing of the transmission price reviews into synchronisation. Ofgem have given approval for National Grid Transco to sell off some of its local gas distribution zones. Ofgem staff are expected to be called as witnesses to a court case relating to a gas explosion in Larkhall.
27. Chris Bolt (**PPP arbiter and ORR**) explained that the Railways Bill was going through Parliament: there had been no issues at the committee stage but there may be some raised in the House of Lords. The Bill allows for rail safety to be transferred to ORR (expected to take place at the end of the 2005). It also writes

in to statute Ministers' duties to give guidance to ORR at the time of price control reviews. As a result of Network Rail under-spending in 2003/04 and overstating its opening debt at the time of the 2003 access charges review final conclusions, ORR was considering making an adjustment to the company's finances equivalent to a RAB adjustment in excess of £1bn.

28. ORR would be looking to recruit a new Chief Executive, Director of Rail Safety Policy, Non-executive Director to specialise in safety and more in-house lawyers.

ITEM 5 Any Other Business

29. ORR would welcome suggestions for future agenda items. It was agreed to speak to Jon Turner with a view to inviting him to do a presentation on CAT themes. Freedom of Information Act would be kept on the agenda for future JRG meetings.