

Ofgem's approach to the valuation of the loss of a comparator in the electricity sector

1. Ofgem's approach to the regulation of the electricity industry differs from that of the DGWS in the water industry, partly as a result of differences in the manner in which the two industries were privatized, as well as differences between the electricity and water supply industries. Moreover, the terms of the relevant statutes differ: in particular, the Electricity Act 1989 does not make any specific reference, equivalent to that in section 34(3)(a) of the 1991 Act, to the making of comparisons between companies. Nevertheless, Ofgem told us that economic regulation of the electricity distribution companies in Great Britain had been based, since privatization, on a regime in which comparative competition played an important part (see paragraphs 8.51 to 8.55 for Ofgem's views).

2. Ofgem regulates prices for electricity distribution companies which are network monopolies. Prices have been reviewed every five years, most recently in 1999, at which time the then Director General of Electricity Supply (DGES) drew on a wide variety of methods in his price reviews, although he used econometric techniques less extensively than Ofwat. He used comparators to help project efficient operating costs and, to a lesser extent, capital expenditure and quality of supply.

3. In the case of operating costs, the DGES used regression analysis as part of the process of determining relative company efficiency. The cost driver was a composite variable consisting of number of customers, network length and units distributed, where the weights of the components in this variable were set on the basis of engineering estimates. An external constraint on the regression intercept (£25 million a year) was also imposed on the model. As the consistency of the data collected from the industry is not as developed as in the case of water, Ofgem needed to adjust companies' reported expenditures. The DGES considered EPN Distribution Ltd and Southern Electric Power Distribution, the licensees for the Eastern and Southern regions, as the most efficient companies and so an efficiency frontier was modelled connecting these points and the imposed intercept, with deviations away from this frontier being regarded as company inefficiencies.

Ofgem's policy on mergers

4. Ofgem has no formal powers in relation to mergers, but advises the Director General of Fair Trading on competition issues. In a policy statement issued in May 2002, Ofgem noted that consumers could benefit from mergers if the combined grouping generated further efficiency savings or improvements in quality of service. Ofgem also stated that 'the threat of take-over can be a continual incentive to management efficiency. However, mergers reduce the role comparators can play at or between price reviews'.¹ Even though companies in common ownership would continue to provide some information separately, comparisons using such data would be weakened as they no longer reflected the efforts of separate management teams. Ofgem noted that the reduction in the number of rivals could result in the efficiency frontier being pushed forward more slowly than would otherwise be the case.

5. Ofgem argued that regulation should not seek to inhibit companies from adopting corporate solutions, such as mergers, that promoted greater efficiency but considered that remedies to offset any detriment to consumers should be considered. Following consultation, Ofgem concluded in the May 2002 policy statement that there was great uncertainty about the size of the detriment from the loss of comparators caused by consolidation in the sector. Recognizing the potential efficiency gains that could be realized from mergers, however, Ofgem proposed a framework where, following a merger, it would seek to ensure that efficiency savings from the merger were passed back to consumers through the price control review process, and that consumers were compensated for the detriment associated with a reduction in the number of comparators.

¹Source: Mergers in the electricity distribution sector—Policy Statement, May 2002.

6. To value a comparator, Ofgem compared the most recent price reviews for electricity distribution companies with those for the National Grid Company (NGC) and Transco, where there are no direct comparators available. The price control settlement for the electricity distribution companies in 1999 included an annual reduction in prices of 4.3 per cent. For NGC and Transco the equivalent reduction was 3 per cent. Ofgem assumed that the difference of 1.3 per cent represented the benefit derived from using comparators in setting price controls. Relative to the controllable operating costs for electricity distribution in Great Britain as a whole, of £1,027 million in 1997/98, the NPV of the total benefits, aggregated over the period 2005 to 2020, was estimated at approximately £351 million. By dividing this figure by the number of possible future mergers at the time to which the base data on operating costs referred (1997/98), Ofgem concluded that a figure of £32 million (at 2001/02 prices) represented a reasonable estimate of the detriment associated with any future loss of an independent management team that should be passed back to consumers, to be spread over the distribution companies in the merged group over a period of five years.

7. Ofgem acknowledged several criticisms of its approach, but nonetheless advocated the approach in order to provide a clear framework which would enable the distribution companies to plan effectively for the future. These criticisms included the following:

- (a) The difference between the price settlements for the distribution companies and for NGC and Transco might be attributable to many factors other than the effect of comparators, including real differences in the network businesses or the realization of a greater proportion of potential efficiency savings.
- (b) Price controls set for NGC and Transco and for the distributors had varied widely at different price reviews and the values identified were sensitive to the choice of a particular price review period.
- (c) The method only considered the effect of comparators on price setting at the periodic reviews with regard to operating expenditure, and did not value comparators for other purposes.
- (d) The detriment arose for all present and future consumers, not just the customers of affected companies, but only current customers of the affected companies were compensated.
- (e) Assigning the required compensation by dividing the total damage by the number of potential mergers assumed that the detriment from all mergers was equal.