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Promoting choice and value for all gas and electricity customers

Update What is a price control?

Ofgem promotes choice and value for all gas and electricity customers, where we can by competition and through regulation only where necessary.

Why do we regulate firms through price control?

Ofgem believes that **competition** is the best mechanism to protect the interests of consumers.

But there are areas of the gas and electricity industry where companies retain an effective **monopoly** and where it may not be possible to introduce competition.

This applies to the **transportation** of energy to customers over national and local networks of **pipes and wires**. Here, incentive regulation, such as price controls are applied to protect consumers' interests.

Who are subject to price control regulation?

The 'pipes and wires' **monopoly** businesses:

- **National Grid Company*** for high voltage electricity in England and Wales
- **Transco*** for national and local distribution gas
- **Scottish Power** and **Scottish and Southern Energy** for high voltage and local electricity distribution in Scotland.
- the 12 companies responsible for **local electricity distribution** in England and Wales.

these two companies have merged to form National Grid Transco but are subject to separate price controls.

What is price control regulation designed to do?

- Ensure that monopolies do not **abuse** their position. For example, an unregulated monopoly might charge too **high prices** and/or provide too **low quality**, resulting in **poor value** for money for consumers.
- Provide companies with a **future level of revenue** and appropriate incentives to meet their statutory duties and licence obligations.

Price control regulation provides **incentives** so companies can:

- manage and operate their networks in an **economic, efficient and co-ordinated manner**
- offer good **quality of service** to customers
- invest in their networks in a **timely and efficient manner**
- help ensure long-term **security of supply** is maintained, and
- make any necessary **changes** to the networks, for example, helping development of distributed generation and increasing reductions in the amount of electricity lost on the distribution networks.

How does the price control process work?

To get the price control process right, Ofgem has to **gather** and **analyse** large amounts of information such as company financial statements and other relevant information.

We use information from other **sources** such as customer surveys and focus groups as well as independent auditors and consultants to provide **specialist** help and support.

Consultation is important. Our documents give regulated companies and other interested parties the chance to **comment** on what Ofgem has said.

Apart from written consultations, Ofgem holds **discussions** with companies, customer groups and other interested parties through, for example, working groups and public workshops.

The price control process is **complex** and normally takes between 18 months and two years to complete.

How does the price control work?

The amount of **money** that a monopoly business can earn on its regulated business is restricted by an **RPI - X price control** that is reviewed every **five years**. It controls prices, not profits, and encourages efficiency within the company.

The RPI - X price control takes the **retail price index** - the rate of inflation - as its benchmark and subtracts X - an efficiency factor - from it.

For example, at a time when annual inflation was 3 per cent, an X of 2 would allow the company to raise prices by no more than one per cent.

The price control also includes incentive mechanisms to encourage companies to deliver what customers require. For example, companies can be **rewarded** or **penalised** depending on the quality of service they deliver.

Price controls provide a company with a level of **revenue** that is enough to finance an efficient business. This is based on an estimate of the **costs** companies face in running their business. These include:

- **Operating expenditure** - this covers the **day-to-day costs of running the network**, such as staff costs, repairs and maintenance, overhead costs etc. An allowance is made to cover the amount of operating expenditure which an efficient company would be expected to incur over the price control period
- **Capital expenditure** - this covers spending on **assets**, such as overhead lines, underground cables and other plant. A projection is made of the level of capital expenditure that an efficient company would incur over the price control period.

  The benefits of capital expenditure are expected to last over several years so companies recover these costs over the assumed life of the asset.
- **Financing costs** - this covers the costs an efficient company may be expected to incur in providing a **reasonable return** to the investors who provide the capital and other financial facilities it requires.
- **Taxation** - the price control must provide **sufficient cashflow** to cover the tax liabilities that an efficient company may be expected to incur, taking into account, for example, the current rate of corporation tax.

What is the timetable for the price controls?

Price controls tend to run for five year periods. The next price control for each price regulated area is:

Electricity distribution	**2005**
Electricity transmission in Scotland	**2007**
Electricity transmission in England and Wales	**2007**
Gas transportation for the whole of Great Britain	**2007**
Gas distribution	**2008**

How is Ofgem looking to develop price controls?

Circumstances facing companies and consumers change over time which means that Ofgem must adapt the **regulatory framework** to continue to meet its principal objective of protecting customers.

Ofgem has been developing a framework to **strengthen** the RPI - X formula and incentive regulation which are at the heart of all monopoly price controls.

The new framework aims at improving the incentives on companies to run their businesses **more efficiently** and invest for the future appropriately, enabling them to operate **more cost-effectively** and bring **extra benefits** for customers.

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