RPI-X@20 Stakeholder workshop

Summary of proceedings

Venue: Ofgem, 9 Millbank, London
Date: 07 November 2008

In March 2008 Alistair Buchanan announced the RPI-X@20 review, a two year project to review the workings of the current approach to regulating GB's energy networks and develop future policy recommendations. The recommendations of the review will be reported to the Ofgem Authority in summer 2010.

The RPI-X@20 review is now underway and the process of open consultation began on 7 November with our first stakeholder workshop. The workshop was well attended, with representatives from a wide range of interested parties.

The session was split into two parts. First, a series of presentations were given by Ofgem and industry representatives. These presentations sparked active discussion amongst attendees on both the process of the RPI-X@20 review and the scope and range of issues that it should address. The slides from these presentations are available at: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=1&refer=Networks/rpix20/publications/Presentations

In the afternoon, attendees were split into four break-out groups, each of which was given a question to discuss. These were:

- Breakout Session 1: Could efficient investment in the networks be better incentivised?
- Breakout Session 2: How could the RPI-X framework be simplified?
- Breakout Session 3: How well are incentives aligned between industry players?
- Breakout Session 4: What are the important features of RPI-X regulation?

There was an active debate of the associated issues at each of the break-out sessions. Discussions focused on both a review of the RPI-X regime to date and prospective challenges and risks going forward. A nominated spokesperson from each break-out group reported back to all attendees, providing a comprehensive summary of the discussion. These summaries have been written up and are provided below to allow a wider audience to review and consider the issues emerging on the day. The summaries have been cross-checked by participants in each break-out group.

If stakeholders have any comments or questions regarding the summaries below or the workshop more generally, please contact the RPI-X@20 team at RPI-X20@ofgem.gov.uk.

Summary of Workgroup Session Discussions

Breakout Session 1: Could efficient investment in the networks be better incentivised?

Notwithstanding the variety of views which were expressed during the course of the discussions in this session, several key themes emerged. These are outlined below.

There was a broad consensus from within the group that RPI-X was not necessarily "broken" but that there are issues with the way in which it is implemented. The following issues were raised with respect to the incentivising of investment in networks:

- The regime may not provide appropriate signals to trigger necessary new investment in a timely manner;

- The RPI-X regime may impose perverse incentives with respect to investment. Specifically, some were of the view that efficient and required investment was often not allowed in full in the RAV and this could result in operators having a disincentive to invest. This was thought to be inconsistent with the original principles and objectives underpinning RPI-X regulation;

- The five year review periods may create artificially short time horizons for investment planning; and

- The regulatory regime may not be sufficiently coherent with government objectives, such as the target to source 20% of final energy consumption from renewables by 2020.

The group suggested that the RPI-X@20 review take account of the following points when considering how to improve the investment incentives framework for networks:

- It will be important for the review to take account of different investment incentive arrangements across the networks and evaluate the effectiveness and performance of these;

- The review will need to recognise that appropriate incentive arrangements may differ depending on the desired outcomes. For example, incentive arrangements used to stimulate the efficient maintenance and use of existing assets may differ from incentive mechanisms required within for growth-related investment; and

- Before making any amendments to the existing arrangements, the review must demonstrate that changes to the status quo represent a clear improvement.

When considering the scope of the RPI-X@20 review, the group noted that the regulatory framework should be looked at in its entirety. A suggestion was also made that a statement of objectives be developed at an early stage of the review. Proposals could then be tested against these objectives.

In terms of potential solutions, the groups recognised that there was not likely to be "one-size fits all" solution given the different challenges faced in different areas of the network. The group also suggested that, in terms of developing an overall solution, a two-tiered approach could be applied. Under this approach, one strand of analysis would involve a focus on the baseline, including opex and existing asset bases, with the other focussed on "new growth", how that connects to renewable targets, and the setting of rules as to how industry will operate while allowing flexibility.

A further suggestion from the group was that, as part of the review, it would be appropriate to investigate further the approach used in Ireland – which was likened to a "centralised planning" approach. It was also suggested that the review consider lessons from the dual regime approach in France where regulation means either a cost of capital of 7.25% or an "enhanced rate of return" for more speculative and growth oriented investment.

Breakout Session Two: How could the RPI-X framework be simplified?

In general, the group thought that complexity per se was not necessarily a "bad thing". However, the group thought that it was important for the RPI-X@20 review to identify the sources of complexity and evaluate whether these were necessary.

Four areas were identified by the group as being potentially complex:

- Capital expenditure information;

- The number of incentives in place and the range of issues they relate to. There was a feeling that some incentive mechanisms may have "outlived" their usefulness. This was underpinned by a perception that the suite of current mechanisms had been built up in an ad hoc fashion and the importance of ensuring that these mechanisms are operating coherently was highlighted in discussions;

- The increased granularity in required reporting and the perception that this continually increases over time; and

- The detailed calculation of the WACC. However, the more simplified approach adopted by Ofgem was welcomed by the group and contrasted to the more detailed approach taken by the Competition Commission. It was suggested that introducing indexation was a possible way of ensuring there was "less agonising" over individual components of the calculation.

Information asymmetry between Ofgem and the companies, uncertainty and attempts by Ofgem to overcome them were identified as the main reasons for perceived complexities.

In terms of the current regime, the group considered that certain aspects should be retained. In particular, the group was in favour of the continuation of an incentive-based regime which encouraged parties to "behave appropriately". The IQI was also perceived by the group as helping to mitigate against the problem of information asymmetry. There was a general concern about the number of incentive mechanisms in place. A radical idea was floated that a list of "priorities" could be drawn up according to the relative effectiveness of each of these measures with the top four then to be "picked" and all others removed.

While it was generally believed that simplification should not be an end in itself, the group also considered that a number of issues should be taken into account when considering ways in which to reduce complexity. In particular, they thought that it was of crucial importance to identify the target audience when considering simplicity. For example, it was noted that companies are likely to have different interpretations to customer groups as to what constitutes a simple and easily understood regime. They also considered that simplicity and clarity would be pre-conditions for the development of a transparent regulatory regime.

The group also discussed possible changes to the regulatory regime which would increase complexity. Here it was believed that:

- although looking to outputs rather than expenditure could help to reduce information asymmetries, it may exacerbate information complexities and this should be taken into account in the context of evaluating the merits of an output-based approach;

- it was difficult to see how the application of a "constructive engagement" approach, similar to that employed by CAA, could be sensibly applied in electricity and gas especially given the questions being raised in relation to its effectiveness in airports; and

- the implementation of longer price control periods would likely lead to more complexity as a result of the need to deal with the increasing uncertainty which was believed would inevitably result.

As noted earlier, the group emphasised that any complexity introduced into the regulatory regime should be warranted.

Breakout Session Three: How well are incentives aligned between industry players?

The discussion in this group was focused on exploring whether RPI-X was providing appropriate incentives to industry players. Several issues emerged.

First, there appeared to be some frustration amongst players wishing to gain access to the network and a perception that network companies have been slow to provide additional capacity for users. Linked to this, the lack of capacity headroom was highlighted as a concern to some and there was a perception that the regime has not been effective in addressing this issue. In this regard, some parties expressed the view that encouraging networks to run near capacity constraints was not in consumers' long-term interests.

The group recognised that perceived transmission access problems in both gas and electricity were managed under incentive arrangements outside of RPI-X but there was a strong belief that they should not be ruled out of scope for RPI-X@20. For some members of the group, this was further supported by a view that some of the long-term reasons for capacity constraints rested with transmission owners governed by RPI-X. There was a feeling that, under these arrangements, the transmission companies had not built the necessary new transmission capacity.

Second, the importance of utilising output measures was acknowledged by the group as a good way to determine the efficiency of investment. However, the difficulties (in relation to defining and measuring these outputs) were argued to be "real" and reference was made to regulators and users being "at a disadvantage" due to information asymmetry.

Some also thought that the definition of efficiency in relation to capex was at least, in some cases, too narrow and some considered that it may unduly discourage network investment. Linked to this, some participants indicated that they believed it to be difficult to engage with Ofgem constructively in a dialogue about long-term (asset) programmes extending beyond the control period in question. Longer price control periods were raised as a possible way of addressing these concerns but the potential for greater risks of reopening was identified as an associated issue.

Further issues raised included the existence of complex incentives and the way that these operate in practise. It was pointed out that very large producers may be less concerned about complexity because they have more resources available to dedicate to understanding these arrangements. There was also an issue, even for large producers, of potential adverse impacts on competition.

The group emphasised the importance of joined up thinking between government and regulatory policy, whilst protecting the independence of the regulators from government.

Breakout Session Four: What are the important features of RPI-X regulation?

This group started their discussion by taking a step-back and reflecting on the question of "what is RPI-X regulation?" Responses included that RPI-X is "a way of regulating monopolies" and that it constitutes "incentive regulation".

In looking at the overall question of "What are the important features of RPI-X regulation?" the group spent a brief period considering the converse, i.e. what were the perceived flaws with RPI-X regulation. Topics discussed in this area included perceptions that there:

- is a disconnect between opex and capex determinations;
- is an implicit assumption that lower cost equals greater efficiency; and
- are rewards for "asset sweating" rather than asset stewardship.

The broad consensus across the group was that participants were "not persuaded" that the regime was broken but that it might need some "tweaking". In this respect, the group highlighted the importance of stability and emphasised the fact that the UK was perceived as having one of the best records in stability of regulation and that this was highly valued by stakeholders. This needed to be taken into account when considering associated costs of any change. Sitting underneath this, there was support for the regime having been "good at" contributing toward asset building.

The group then considered how the regime should evolve in the future. The following key issues were identified:

- There are likely to be diminishing returns achieved from benchmarking the performance of companies that are all increasingly moving toward the frontier. In this context, it was believed that using metrics to differentiate companies will become of greater importance;
- A view was expressed that knowing how the regime will respond in an unstable environment was a "good start" and that predictability in the regime was therefore important;
- It would be important to know whether the regime meets the wants of those it impacts on and whether it delivers value for money in investment;
- On the issue of risk and reward between companies and consumers there was an open question as to whether additional risk for additional reward was captured by the regime and whether this should be captured in the future; and
- There is a need for greater transparency, although the group recognised the difficulties related to information asymmetry. However, alongside this, there was recognition among the group that increasing complexity also has associated issues in terms of engagement and understanding.