



27 FEBRUARY 2009

R/10

## OFGEM OPENS MAJOR REVIEW OF REGULATION

- More than 20 per cent of customer energy bill under review
- First review of pipes and wires regulation in 20 years
- Part of Ofgem's "tomorrow's customers" initiatives

RPI-X@20 is one of a number of forward-looking projects at Ofgem designed to ensure that Britain's gas and electricity industries meet the needs of consumers, now and in the future, and pave the way for a low-carbon economy. Not only does this represent a wholesale review of the core business of Ofgem (pipes and wires regulation), but it significantly affects consumers as it impacts on at least 20% of the energy bill.

This is the first consultation in a root and branch review that could re-shape the future of energy network regulation. The regulator is re-evaluating the regime that has governed the revenue and expenditure of the energy networks for almost 20 years. The review, *Regulating Energy Networks for the Future - RPI-X@20*, will ensure that regulation of Britain's energy networks is fit for purpose in the face of new environmental, economic and social challenges.

The current regulatory regime is based on pegging revenue growth to within a given percentage (X) of the retail price index (RPI) with X decided at five-yearly review. This framework has served customers well for twenty years – with network charges halved whilst investment has increased and quality of service improved. But the review will look at whether changes need to be made to build on these successes but be flexible enough to allow substantial changes in the role of energy networks over the coming years.

This is supported by recent groundbreaking Ofgem research from leading academics looking at what sort of energy networks we might need in 20 and 40 years time.

Ofgem chief executive Alistair Buchanan said: "RPI-X@20 provides us with the opportunity to step back and think hard about whether we have in place a regulatory framework that will continue to deliver for consumers, be flexible in the face of greater uncertainty, and facilitate the move to a low carbon economy."

-ends-

## Notes to editors

### 1. Themes for the review

There are two themes to the review:

- focusing on the needs of current consumers and those of future consumers; and
- delivering a sustainable energy sector.

The focus on customers will mean understanding better the needs of consumers, and ensuring that networks provide value for money. Sustainability in energy will include the delivery by regulated networks of targets for security of supply, climate change and social (particularly fuel poverty) targets.

Our work on what sort of energy networks we might need in 20 and 40 years time concluded that with the drive to decarbonise the energy sector they are likely to be radically different. But with new technologies being developed all the time the future is very uncertain. We may need much larger networks to transmit much more carbon-free renewable and conventional energy from large power stations to peoples' homes with rising demand from electric vehicles. But smart grid technology, energy efficiency and more local generation could require much smaller networks.

### 2. Phases of the review

- **Visionary phase:** In the first phase we aim to understand the issues affecting network regulation, identify areas where change may be needed to accommodate these, and identifying possible regulatory models for the future. We are ruling nothing out of scope in this stage. The phase will culminate in the publication of an emerging thinking consultation document in November 2009.
- **Options development phase:** The second phase will involve the narrowing of the scope of the project and a detailed working up of options identified as having high potential. This phase of the project will culminate in a set of conclusions and recommendations that will be consulted on in spring 2010 before being delivered to the Authority in summer 2010.

We believe that this initially broad scope is necessary. Since the review was announced, there have been a number of legislative changes and developments in EU and GB energy and environmental policy. Our understanding of the uncertainty facing networks has also developed, driven by our Long-term Energy Network Scenarios (LENS) study, the energy market review, and ongoing monitoring of the gas and electricity markets. At the same time, we have observed significant changes in financial markets and the wider economy.

### 3. Engaging with consumers

Consumers will have the opportunity to contribute to this review in a number of different ways:

- **Consultation documents:** Responses are welcome to our February 2009 'Principles, Process and Issues' paper. We intend to publish two further consultation documents and a final decision document. These documents will provide an update on our thinking and allow interested parties to formally express their views.
- **Seminars and workshops:** From the inception of RPI-X@20, we have sought to engage with interested parties through workshops and seminars. We will continue to do so during 2009 and 2010.

- **Working groups:** It is clear that there is a wide range of issues to consider in RPI-X@20 and a number of interested parties have expressed an interest in getting more involved with the review. We are therefore proposing to establish small working groups to develop thinking on specific issues during 2009.
- **Web forum:** We launched the RPI-X@20 web forum in November 2008 (<http://www.ofgem.gov.uk/Networks/rpix20/forum/Pages/forum.aspx>). You will find our publications on the site, as well as papers from academics and consultants. We are hoping that other interested parties will submit pieces to stimulate debate.

#### 4. Guiding principles

- **Consultation:** We will consult with interested parties throughout the review to ensure all parties are given the opportunity to engage with us and have their views heard.
- **Transparency:** We will be transparent in the way we undertake this project and in how we arrive at conclusions and recommendations. We will place key documents on our website.
- **No surprises:** Our transparent and consultative approach should leave interested parties aware of the direction of the rationale underpinning Ofgem's recommendations.
- **No retrospective action:** RPI-X@20 will be focussed upon the framework for future regulation of energy networks. There will be no reconsideration of decisions taken in the past. Any recommendations from RPI-X@20 will apply, at the earliest, to the Transmission Price Control Review for 2012-17.
- **No stranding of efficient investment:** We will ensure that suitable funding arrangements are incorporated into any framework adopted at the end of this review. We will also consider how best to take forward the potential stranding of future efficient investment in any new regulatory framework.

#### 5. RPI-X successes

- Price controls have driven down the revenues that network companies are allowed earn from their network charges. Since the network companies were privatised allowed revenues have declined by approximately 60% in electricity distribution and 30% in electricity transmission (allowing for increases in the current period driven by increased capital investment). Allowed revenue for gas transmission and distribution declined by approximately 35% between 1995 and 2002, and by a further 10% between 2002 and 2007. Allowed revenue for gas transmission and distribution has increased in the current period, reflecting the large capital investment programmes in each sector. The reductions were possible despite ongoing capital investment across the sectors since privatisation.
- There is evidence to suggest that operating efficiency has increased, for example real unit operating expenditure has fallen by approximately 5.5% p.a. across the electricity distribution networks since privatisation, and we continue to set incentives to encourage the energy network companies to improve their operating efficiency.
- Capital investment in the electricity networks is higher on average than the period immediately prior to privatisation. There has also been significant investment in the gas distribution and transmission networks, including the recent programme to replace cast iron mains.

- The allowed pre-tax return has typically sat within the range of 6-7% in price control settlements and companies have, in response to the incentive regime in place, earned higher returns by beating the regulatory contract. This has been confirmed by our recent analysis of the return on regulatory equity earned by electricity and gas distribution companies. For example, recent Ofgem analysis has estimated that actual returns across the electricity distribution networks over the current price control period may differ from the assumed norm by a variation of +3.5 to -1.5 percentage points. Applying this same technique to the gas networks has returned a variation of +6.5 to +0.5 in actual returns across the gas networks over the past year relative to the assumed rates.
- The quality of service delivered to customers has improved, with a 30% reduction in both the number and duration of reported power outages between 1990 and 2008. The number of unplanned customer interruptions in gas has also remained at a low level (less than 0.5 per 100 customers annually) since 2003. Improvements have generally arisen in response to quality of service incentives put in place alongside, or within, the RPI-X framework.

In recent years, however, we have observed changes. At the most recent price reviews, we have allowed stable (RPI+0) or increasing (RPI+X) prices. Companies continue to have incentives to reduce costs, for example through the adoption of new business models, but the scope for further large-scale reductions may be limited. Networks, including the offshore regime, are also forecasting large investment requirements going forward. For example, in TPCR4 the transmission companies forecast capital expenditure of £5.1m<sup>1</sup> for the period 2007 to 2012. This was a 100% increase on the previous period. The combination of increased investment, and potentially reduced operating efficiency savings, could place significant upward pressure on network charges

## 6. Challenges

The energy sector is expected to play a leading role in delivering sustainable development for the future (incorporating security of supply, environmental targets and social targets). There is significant uncertainty about what this means for the future role and direction of networks. Our Long Term Energy Network Scenarios (LENS) project has shown that delivering a sustainable energy sector will require innovation, to ensure existing network assets are used effectively and any further capital investment is efficient.

There is uncertainty about the precise details of current and emerging energy and environmental policy at national and EU level.

There are questions about the level and variability of charges, and more generally concerns about whether networks are providing value for money for consumers.

There is uncertainty about the potential impact of the current global credit crisis and the downturn in the economy on network performance, and on consumers.

**7. Ofgem is the Office of the Gas and Electricity Markets**, which supports the Gas and Electricity Markets Authority, the regulator of the gas and electricity industries in Great Britain. The Authority's powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002, the Energy Act 2004 as well as arising from directly effective European Community legislation.

### For further press information contact:

**Chris Lock**                    **020 7901 7225 / 07766 511470**  
**Alison Wright**                **0207 901 7217 / 07771 980297**