British Gas

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Dear Hannah

Centrica Response to the RPI-X@20 Review Consultation - April 2009
Executive Summary

1. Centrica welcomes the opportunity to respond to this important consultation. We are the largest integrated gas and electricity company in Great Britain that does not own any energy network interests. We are therefore uniquely placed to provide an unconflicted perspective on the RPI-X@20 review.

Role of Government and making investment happen

2. The competitive energy market faces unprecedented challenges in the next decade and beyond, particularly in undertaking the necessary investment to deliver the Government's environmental agenda. To meet this challenge we believe Government must be brought more explicitly and openly into the regulatory process. While Government should not and need not be directly involved in the detail of individual regulatory decisions, it would be helpful if its high-level objectives can be factored into the detailed regulatory decision-making process.

3. Clear statements from Government on key areas of policy would allow Ofgem to ensure determinations are consistent with Government policy. Improved customer engagement will also be necessary to ensure that an appropriate level of investment is undertaken to meet the Government's policy objectives.

Meeting needs of customers

4. The RPI-X regulatory methodology has been successful in many respects. However the framework has been less successful in promoting efficiency in capital expenditure. This is a critical issue given the forecast growth in capital expenditure in coming years. One of the main problems with the existing process is a lack of engagement by the networks with stakeholders when determining their capital expenditure plans. To improve this engagement, we believe significant changes to the regulatory framework are required.

5. Network business must improve transparency and predictability in all aspects of their planning processes. This means information released by network businesses should be more meaningful, and networks should be required to present and consult on their capital expenditure plans in a formal, structured way to the full range of their network users and stakeholders.

6. It may be appropriate for improvements in the way networks engage with customers to vary by sector (in line with the current extent of such engagement), with more fundamental change being necessary for those sectors where stakeholder engagement by the networks is currently lowest (i.e. in distribution). However, we consider one clear way in which customer engagement could be enhanced in all sectors would be by allowing suppliers and customers to appeal price control outcomes on the same basis as the networks. This would ensure that the networks engage more effectively with all relevant stakeholders, rather than focusing purely on their relationship with Ofgem.

7. A lack of customer focus by the networks has also led to networks paying little regard to how network costs flow through into the charges faced by suppliers. This has resulted in a lack of transparency and predictability in network charging, and distortions in supply competition. Proper processes therefore need to be put in place to manage the interaction between determinations of allowed revenues (including reopeners) and the recovery of those revenues from competitive market participants.

8. Lastly, a greater degree of stakeholder engagement may help to promote a more efficient allocation of risk between parties (with risks being allocated to those who are best placed to manage them). In some areas this has not been the case in past (such as cost of capital, where we believe an indexation approach would have been likely to delivered a more efficient allocation of risk between the networks and customers).

Balancing risk, reward and performance of the networks

9. This review must deliver a framework that produces better value for money for customers. This means the networks should receive rewards that reflect the performance they deliver and the risks they bear. We therefore welcome transparent and top-down measures of rewards earned by the networks, such as Ofgem's RORE analysis.

10. However Ofgem's analysis clearly shows that the gas and electricity network companies are currently able to obtain substantial out-performance and windfall benefits, often for no clear benefit to consumers. This, together with the lack of any network company challenging an Ofgem price control decision at the Competition Commission since 1997 suggests the balance is not right between company and consumer interests at present.

Introduction

11. In total, Centrica spends around £2bn on gas and electricity network charges every year, meaning that we therefore pay, on behalf of our customers, a large portion of the revenues that the network businesses earn. We consider that getting the process and structures for price control regulation right is the key starting point for this review, and the detailed application of incentive based regulation will follow on from establishing an appropriate regulatory framework.

12. We consider that there may be differences in approach required between transmission and distribution, and between gas and electricity. However, these differences are within the context of common principles. We have focused our response on three key themes:
    - Role of Government and sustainable development;
    - Meeting needs of consumers; and
    - Balancing risk, reward and performance of the networks.

Role of Government and sustainable development

13. Centrica, as an organisation that is active in all parts of the energy supply chain, recognises that the sector faces huge challenges in meeting the Government's environmental objectives, maintaining security of supply and keeping consumer bills at a reasonable level to address the issue of fuel poverty. We recognise the tensions between these objectives, and particularly between the Government's environmental objectives and consumer preferences for affordable energy.

Delivering the required level of investment

14. Although estimates of the level of required investment vary considerably, it is clear that the scale of investment required in coming years is unprecedented. The Electricity Networks Strategy Group (ENSG) reported that c. £4.7 billion of investment would be needed to upgrade the electricity grid network in order to accommodate new power generation by 2020. Looking more widely, one independent assessment has concluded that the capital expenditure required to develop a sustainable energy sector to 2025 will be at least £234 billion[1]. Clearly this level of investment will only be undertaken if investors have confidence that the regulatory framework will allow them to earn returns of a sufficiently high and stable level (and for a long enough period) to make investments commercially attractive.

15. However, the regulatory framework is currently subject to numerous important reviews and initiatives including the Transmission Access Review, the recent exit reforms, the Governance Review and the Probe remedies relating to improving the consumer experience as well as the RPI-X@20 review. Until they are concluded, considerable uncertainty in the energy sector will persist.

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[1] Securing the UK's energy future – meeting the financing challenge, An update to the Ernst & Young 'Costing the earth? The impact of climate change mitigation on UK domestic customer energy bills' study, February 2009

16. We believe there are two ways in which this uncertainty can be reduced. Firstly, we would suggest improving the involvement of stakeholders in the review processes, and ensuring that their views are properly reflected. This will help to ensure that the reviews deliver consistent outcomes, and will also help to achieve an appropriate balance between the competing objectives facing the industry. This should include greater clarity in the way in which, for example, capital expenditure plans are explained to customers, including clear descriptions of the underlying objectives of each proposed package of investments.

17. Secondly, Government needs to be brought more explicitly and openly into the regulatory process, so that its objectives can be factored into regulatory decision-making. If the energy sector is to be able to make the difficult choices involved in reconciling the trilemma of decarbonisation, security of supply and affordability, regulatory processes will need to be reviewed to ensure they provide the right balance between a flexibility to respond to changing priorities, while also providing sufficient certainty on key issues to enable investment to be undertaken.

18. We therefore believe there is a case for increased and timely Government involvement in regulatory processes, such as eliciting statements from Government clarifying which review outcomes would be most consistent with Government objectives. So long as this guidance is provided at a strategic level, such involvement would complement the role of Ofgem, enabling it to focus on detailed decision-making (informed by the views of market participants) in a way that is clearly separated from the political process.

User engagement

19. While giving industry sufficient incentives and a stable regulatory framework to deliver an appropriate level of investment will be a challenge, ensuring that this investment is correctly targeted and efficiently delivered will be just as difficult. We believe that this can only be achieved by ensuring that customers are fully engaged in investment planning, and at as early a stage as possible.

20. In terms of transmission, we note that to date the transmission owners have not been willing to undertake anticipatory investment, particularly ahead of the predicted growth in renewable generation, and this is now impacting their ability to provide connections in the required locations. We therefore believe the networks need a coordinated blueprint for grid investments to 2020 and beyond.

21. We believe that the ENSG represents a good model that Ofgem can build on for TPCR5, showing what can be achieved when there is a sufficient commonality of interests to achieve high level goals, and that transmission companies and stakeholders can work together. An approach similar to ENSG could be used to provide a coordinated anticipatory investment plan, forming a blueprint for the levels of network investment that industry consider necessary.

22. We consider that this type of approach is a constructive way of agreeing an appropriate level of anticipatory investment, which the network companies should be able to view as being low risk. We would encourage Ofgem to consider this type of user engagement process as a complement for existing user commitment approaches.

23. More rounded stakeholder engagement and user commitment processes should lead to better investment decisions being made. While user commitment plays an important role in protecting customers from the risk of underutilised network investment, it may not always be sufficient in its own right, particularly where even a small shortfall in network capacity can have disproportionate implications for end consumers. For instance, a "tight" gas transportation network may avoid extra network investment costs, but instead displace costs and risk into the wholesale gas market in the form of higher gas prices.

Meeting needs of consumers

24. We agree that a priority theme of the RPI-X@20 review should be "focusing on consumer needs", and we welcome the central place this has been given in Ofgem's review. We believe there are numerous aspects of the current regulatory framework that are helpful in promoting customer engagement, such as the development of the Expert Consumer Panel for the Electricity Distribution Price Control Review (DPCR5). It is also clear that over time Ofgem has improved its consultation processes, with the last GDPCR providing suppliers with more information and greater access to Ofgem senior staff than ever before.

25. However, we do not believe that initiatives such as these address the underlying problem of a lack of direct and useful customer engagement by the network businesses in the development of their business plans, or by Ofgem in determining the outcome of the price control process. While the current approach does give consumers the opportunity to be involved in consultations throughout the price control review process, their views do not seem to be central to the outcome.

26. Importantly, the potential implications of business plan and price control policy proposals for network charges suppliers pay are often unclear. Improvements in transparency and simplicity in this area in particular may significantly increase meaningful and informed engagement by network users.

27. There is a range of evidence to suggest that historically in the energy sector (and other regulated sectors) price control settlements have been overly generous to regulated network companies, reflecting a lack of focus on consumers' interests. Specifically, the distribution networks appear to be systematically outperforming the price control settlements. Ofgem is forecasting that all electricity DNOs except one will outperform the price control settlement (with a spread of expected outperformance between 3.5% and -1.5%). For gas distribution the spread of outperformance for 2007/8 is between 6.5% and 0.7%.

28. We believe that Ofgem's starting presumption should be that on average networks do not earn more than the cost of capital that has been set. If additional incentives are then set that have a positive expected value for the networks, then Ofgem should make an equivalent offsetting adjustment to the cost of capital

Ensuring that network users are central to the process

29. Although we believe there are many aspects of the current price control process that are helpful in reflecting the views of network users, at present customer engagement is not central to the process. Instead, views are often expected to be submitted on the basis of a review of opaque data submissions and complex arguments made by the network businesses. A good example of this is the lack of transparency around the underlying drivers of the large proposed increases in capex by the distribution networks. This complexity and general lack of transparency makes it difficult for any third party, especially consumers, to become effectively involved. Ofgem's workshops have also indicated that network companies are often focused on Ofgem rather than consumers.[2]

30. A further example of this lack of customer focus by the networks relates to network charging methodologies. At present, networks have no real incentive to engage customers in the way in which they develop their charges. This means that, although network users may value a wider range of network charging "products", these are currently not made available to them. A good example would be a product in which charges by the networks are fixed for a specified period of time to provide users with greater certainty and stability.

31. We believe that placing network users at the heart of the price control process can be a way of changing the attitude of network businesses towards customer engagement. If users have a clearer impact on the outcome of price controls, then it will be in the interests of network businesses to solicit the views of network users earlier in the process, and in ways that are more meaningful and productive than at present. We also note that placing consumers as more direct stakeholders in the process is being considered in other regulated sectors undergoing reviews.[3]

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[2] Ofgem (2009) "Regulating energy networks for the future: RPI-X@20, Principles, Process and Issues", p.23.

[3] The Department for Transport is currently consulting on options for a new appeal mechanism for airport regulation, which includes options to give airlines and other consumer representatives rights to challenge price control proposals other than through judicial review.

32. There are numerous ways in which network users can be placed more centrally in the price control process. As we shall discuss more in following sections, focused and structured engagement with network users on specific issues is one approach. However, we would favour allowing suppliers and customers under certain circumstances to appeal price control outcomes on the same basis as the networks. This would be the clearest way of ensuring ensure that the networks engage more effectively with all relevant stakeholders, rather than focusing purely on their relationship with Ofgem[4]. Both the regulated network companies and Ofgem would know that ultimately a price control settlement had to be a package that was acceptable to suppliers and consumer representatives. Without any other changes, this could be expected to substantially change the focus of companies' and Ofgem's work.

33. We also note that the extent of customer engagement varies significantly by sector. In transmission, for example, engagement with network users tends to be relatively high and transparent. In contrast, customer engagement in distribution is not as clear, possibly partly as a consequence of the more integrated market structure. We would therefore suggest that regulatory remedies to improve customer engagement may need to differ by sector, ensuring network companies engage with their key stakeholders in the most effective way for their audience.

Promoting transparency

34. One of Centrica's biggest concerns about the current price control review process is the lack of transparency around network companies' business plans, and the potential impact of these on the predictability of network charges. The current DPCR5 process is a useful illustration of this. Although network businesses publish data on their business plans, this is not presented in way that is meaningful to the majority of network users. This lack of transparency – even of the main drivers behind the large increases in capital expenditure being proposed – restricts the potential for network users to provide meaningful views. We suggest this is remedied before the massive expenditures predicted to be needed in the next electricity transmission control are discussed.

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[4] Note that we do not discuss here the exact details of the appeals process, and these would need to be carefully considered. However, we are more interested in the principle at this stage and are certain that an appropriate detailed set of rules could be put in place.

35. Clearly it would not be appropriate or efficient for network users to duplicate Ofgem's role in reviewing companies' business plans. However, if network users are to provide a counterbalance to the views presented by network businesses, then transparency of the information published as part of price control processes, and the implications of policy alternatives needs to be improved.

36. One important way in which this transparency could be improved would be to indicate the materiality of network business plans (or elements of plans) and policy proposals for network charges, together with sensitivities to potential changes. As we discuss more below, we are also very supportive of the introduction of Ofgem's RORE analysis. We believe that a similar "top down" approach to the network charge implications of change proposals and business plans would be similarly beneficial. This would allow network users to engage on those areas that are of greatest materiality, as well as promoting greater predictability in network charges.

Allocating risk efficiently

37. Ofgem and network companies need to fully recognise the detrimental impact on supply competition of unpredictable charges for transmission and distribution. End consumers place a high value on predictability of their charges, and in response to this Centrica offers fixed-price contracts to both domestic and non-domestic customers. At present, around 25% of household customers have fixed-price arrangements. Suppliers levy risk premia to mitigate the impact of unpredictable network charges, and where risk is inappropriately allocated this leads to inefficient outcomes for the end consumer.

38. Centrica believes much greater thought needs to be applied to how price control mechanisms and business plan proposals affect charging predictability. For example, the application of specific reopeners during price control reviews may reduce risks for network owners, but instead passes these directly to suppliers. As a result, network charges can change materially at short notice, which makes them very unpredictable – especially when most network owners are unwilling to disclose details of potential exposures and sensitivities.

39. A "top down" approach to managing charging predictability (such as the use of logging-up) would be one way of helping to improve predictability. Under this approach, any net additional costs that arise due to re-openers would be taken into account at the next periodic review. This creates more certainty about the costs for the current price control period.

40. However, we recognise that it may not be appropriate for network businesses to bear all risks and instead that risk should be allocated to those parties that can manage it most effectively. A good example of this relates to the treatment of cost of capital, an area where there is great uncertainty at present. In this case, we do not think that the "headroom" approach in which DNOs receive a premium over the observed cost of capital at the time the price control is agreed is the appropriate way of managing this risk. Instead an "indexation" approach where a (predictable) mechanism of cost of debt adjustment for DNOs would deliver better value for network users and end consumers, delivering significant annual savings while also reallocating risk more sensibly between DNOs and end consumers at a time of great financial uncertainty. We would be very happy to work closely with Ofgem to develop these ideas further.

41. In addition to the charges consumers face for the supply of energy, uncertainty about the risk/ reward balance can lead to delays in investment decisions. This generates uncertainty about the extent of any benefits and the timing of those benefits and hence may impact on investment decisions. A good example of where uncertainty can have detrimental implications for investment is in the proposed offshore regime. The arrangements under which this regime will operate are not yet finalised. However given the scale of the required investment in offshore windfarms necessary to meet the Government's sustainability agenda, it is important that this uncertainty is removed as early as possible. We also recognise that, due to the different nature of the onshore and offshore networks (particularly in terms of time to repair faults etc.) there may be good arguments for the detail of the onshore and offshore arrangements to differ in some areas.

Balancing risk, reward and performance of the networks

42. The analysis of RORE by Ofgem illustrates that the gas and electricity network companies are able to obtain substantial out-performance and windfall benefits, often for no clear benefit to consumers.[5] This, together with the lack of any network company challenging an Ofgem price control proposal at the Competition Commission since 1997 suggests the balance is not right between company and consumer interests.

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[5] Obviously Centrica is supportive of companies that earn higher returns through clear management performance to beat fairly set targets. What is not appropriate is windfall benefits arising from incorrectly specified targets or the natural conservatism of the companies/regulator.

43. To address this, we believe Ofgem should have a starting presumption that on average network companies should not earn more than the cost of capital. However, the current arrangement seems to imply a systematic positive expected value or out-performance. This is borne out by analysis undertaken by Ofgem as part of the RPI-X@20 review which indicates 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. For the gas network, this variation is +6.5 to +0.5 in actual returns relative to the assumed rates. This implies that, on average, network operators are earning returns above the expected level of zero and there is no evidence that they are taking on additional risks in order to earn this higher return.

44. While Centrica welcomes genuine improvements in efficiency, too much of the out-performance does not appear to reflect this, but instead an inherent generosity in the price control settlement, e.g. a fixed cost of debt set at a conservative level and generous incentives such as the distribution losses incentive.

45. We also believe that, while RORE is a welcome addition, there may be further ways of increasing *ex post* transparency of price control settlements. This could include additional qualitative analysis of how the control is working, what improvements have resulted (in terms of tangible outputs) and what, if any additional costs (or indeed claw-backs) can be expected.

Yours sincerely,

pp Philip Davies
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