RPI-X@20

Summary of issues discussed at our stakeholder workshops

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Ofgem Offices, 9 Millbank, London

The RPI-X@20 stakeholder workshops provided interested parties with a high level overview of progress over the Summer and early Autumn including our working papers and consultant reports. They were an opportunity for stakeholders to discuss the issues raised to inform our "Emerging Thinking" consultation document (Winter 2009).

Hannah Nixon introduced the workshops by outlining the purpose of the review, setting out progress since February's "Regulating energy networks for the future: RPI-X@20 Principles, Process and Issues" consultation document, and outlining next steps to the production of the "Emerging Thinking" consultation paper.

She also highlighted the external papers prepared by the four industry working groups and thanked members of the groups for their contribution.

Cloda Jenkins then presented each of the issues addressed in the summer's RPI-X@20 working papers and other major areas of work, including those where consultant reports are available. The presentations can be found here: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=45&refer=NETWORKS/RPIX20/PUBLICATIONS/PRESENTATIONS

Participants then split into break out groups which were able to discuss any issues that they thought pertinent. Some of the discussions were structured around the following questions provided by Ofgem.

- How should we judge success of RPI-X@20?
- From what we have examined in our working papers and in consultant reports, are there any issues that you think are missing? How would you prioritise the issues?
- What do you want the future regulatory framework to include and why?
- You might think of this across a range of subjects including:
- What the regulatory framework should be trying to deliver;
- How you ensure effective and efficient delivery;
- How should the regulatory framework facilitate innovation;
- What is the appropriate role for consumers in relation to the regulatory framework;
- How should the regulatory framework deal with changes over time?

- What are the key differences between electricity transmission, electricity distribution, gas transmission and gas distribution networks that we need to consider?

Each break out session was conducted under Chatham House rules. A summary of these discussions is set out below.

Success of RPI-X@20

Delegates made suggestions on the criteria by which the RPI-X@20 project should be judged a success. Views included the following.

- The review will be successful if the resulting regulatory framework acts as an effective mechanism for the delivery of policy objectives set out by the government. It was noted that the networks are simply one part of the delivery of the outcomes associated with the carbon targets but that they should not be a delay to others connecting.

- The framework should protect the interests of consumers – if this is successful, consumers should not be aware of changes in the regime.

- It was noted that judging success based on consumer satisfaction might be challenging as consumers may be hostile to the environmental agenda driven by the Government. However, delivery of environmental targets, whether or not consumers' agree, would be seen as a success factor – though difficult to judge in the short term.

- For several delegates, delivering value for money to consumers was regarded as the most important issue. However, it was also suggested that some consumers would rate reliability of supply as the most important success criteria.

- It was suggested that the Distribution Price Control Review 5 (DPCR5) measure of success could be applied to RPI-X@20 over a longer time period. This measure was phrased in terms of companies that make highest return being those that deliver the most. There was debate about whether it was appropriate for companies to earn significantly above average or below average returns for sustained periods, and whether there would need to be some form of caps and collars.

- One measure of success might be predictability for customers of what network charges they will pay. While low charges were seen as desirable, it was recognised that this should not necessarily be seen as a gauge of success, given that the sustainability challenge is likely to drive network charges higher.

- The potential trade off between higher, more predictable prices and lower, more volatile prices was noted with the latter providing efficiency signals.

- The framework should allow innovation on the networks to take place.

- An important criterion to judge success was the ability of the regime to adapt over time and flex to uncertainty.

- Success could be judged by looking at how many of the ideas from the regulatory regime are adopted by other regulators.
- It was suggested that success of the project should not be regarded as a radical change from the regulatory regimes that are now in place.
- The regime should not introduce undue regulatory risk as networks need to be able to take forward investment at a reasonable cost.
- It was suggested that failure of the regime would be seen where networks act as a barrier to innovation or the achievement of sustainable development or if networks perform their role to the detriment of consumer interests.
- It was highlighted that the review's documents should be easy to understand for all parties as well as those in the industry.
- There should be a clear understanding of what has to be delivered by firms and a recognition that this is about more than delivery of serviceability in the future.
- Consumers should be the priority, although there needs to be a recognition that this may clash with environmental objectives.
- The original ambition of simplicity should not be forgotten.
- The review needs to have a wide profile, for example with workforce in the networks, and conclusions need to be understandable. Need to demonstrate that the review matters to a wide audience.
- It was suggested that the RPI-X@20 review needs to be focused on networks and take holistic energy policy as given. Impacts of other reviews, such as Project Discovery and TAR, needed to be considered.

What issues are missing from the review?

The discussions did not identify a significant number of issues that delegates thought were not being given due attention in the review. It was suggested that there needed to be a greater sense of urgency to the completion of the project. This is needed to find a way to address the impending carbon targets.

In the discussions it was emphasised that RPI-X@20 needs to have regard to the potential for the government to change in the next six months and the impact that this may have on Ofgem's role and duties. The need to consider employee safety and skills requirements was also highlighted.

A further area identified as something that Ofgem needed to consider was the appropriate level of specification of network. It was suggested that an underspecified network would create bigger issues for consumers than one which is over-specified, especially given new technologies e.g. electric vehicles.

One delegate suggested that Ofgem as an organisation should attempt to outline the "big picture" and highlight "what we want to achieve", seeing RPI-X@20 as a key opportunity to facilitate this. From here it was suggested that the success of the new regime would be easier to measure through the implementation of a clearer "goal".

There was discussion on what the "goal" might be and how it relates to what networks should look like and deliver.

Views on the current regulatory framework

Discussion around whether RPI-X was still fit for purpose left conflicting views. It was suggested that Ofgem's DPCR5 was delivering the aims of the RPI-X@20 review. However, it was argued that this only accounts for electricity distribution and that RPI-X isn't working in terms of electricity transmission where a backlog of much needed renewable energy is being prevented from connecting to the electricity transmission network.

Further discussions around the current regime highlighted the influence this has on firms to see operating expenditure as "bad" and capital expenditure as "good". It was argued that networks were being incentivised to overspend on capital expenditure. However, it was also argued that, being businesses, networks would not overspend unnecessarily.

One delegate highlighted that the industry still had an ageing workforce, despite the previous two price controls giving ex-ante allowances specifically for the recruitment of apprentices. This then led to the suggestion that networks should be placing a greater emphasis on skills within its workforce and promoting greater expertise where necessary to better equip the companies.

It was suggested that networks plan in terms of the current 5 year price control, and that 15-20 year planning is more difficult. Longer term planning is not incentivised and hence not generally carried out. This issue was considered important and one which should be dealt with by the new regime. However, others suggested that although commitments beyond 5 years were necessary, stretching the regime past this amount of time may also stretch its credibility due to the difficulty of making any predictions or commitments past this. Some also argued that extending the price control period could reduce learning in the regulatory process and delay Ofgem from addressing problems that arise.

The difficulty large users have in connecting to the networks was considered an important barrier to success by some participants. A few suggested that networks are often not given enough notice for connections while others believed that networks sometimes use a 'blank cheque' for the cost of a connection. It was suggested that this is a key issue.

Some participants perceived current losses incentives, particularly as applied to electricity distribution networks, as ineffective, because of large measurement errors (e.g. theft versus infrequent metering versus technical losses). It was also argued that the arrangements were not effective in rewarding benefits of investment, impacting on investment appraisal decisions (e.g. deterrence of innovative approaches that could substantially reduce losses, albeit at a higher short term cost). It was suggested that addressing these issues might require a more intrusive approach, though it was recognised that smart metering infrastructure could make some difference in the future.

Innovation

Several delegates highlighted that the RPI-X@20 project should look for different ways to fund innovation. For example, it could allow a higher return in order to encourage innovative investment. It was suggested that innovation may be ring-fenced from the main price control.

One delegate highlighted that rather than looking at giving companies rewards for innovation, RPI-X@20 should consider imposing penalties on them for not innovating. Others emphasised that the regulatory framework should not be a barrier to innovation rather than being the driver behind it. It was also emphasised that Ofgem should not pick winners through the regulatory framework.

One attendee commented on how heavily investment is highlighted by Ofgem. This fuelled a discussion where some thought that innovation does not necessarily need to be incentivised by the regulator, whereas others pointed to the steady fall in R&D spending by networks since privatisation, up until the innovation fund incentive (IFI) was implemented.

While some indicated that they believed the IFI had been effective in generating ideas, there was some support for a fund that non-networks could also access. However, it was questioned whether this would work in practice. Some also questioned whether there may be merits in exploring whether any "shackles" relating to licensing restrictions on network activities could be loosened in aid of facilitating innovation e.g. upstream innovation in bio-gas or downstream in heat storage. To this end, it was suggested by some that networks be allowed to participate in generation activities.

Several delegates noted that they expect innovation to occur at the edges of networks and this is the area where we need to consider ensuring that the regulatory regime does not pose a barrier. Supporting this were comments stating that networks are not the main parties carrying out innovation and that a significant amount is occurring, and is likely to occur, led by non-network companies e.g. electric vehicles and heat pump manufactures. As such, it was suggested that rewards for innovation should not be constrained to network companies. The way in which networks deal with the innovation of these other parties was seen as important; as well as the view that any innovation fund should be made available to these other companies as well as networks.

The scope for innovation in gas was seen as more limited than in electricity although there was a suggestion that operational innovation would be needed. One group also emphasised that innovation needed to go beyond technical innovation to include innovation in service offerings (e.g. connection arrangements) and structural innovation (e.g. network being allowed to have embedded generation to balance system).

It was noted that there was huge uncertainty over the impact of smart metering. There was also uncertainty over the networks' role in developing and operating smart grids.

Underpinned by a view that decarbonising the sector would involve implementing technology which already exists, some believed that relevant questions were limited to how this could be achieved efficiently and what the budget would be for doing so.

Some delegates also suggested that Ofgem needed to innovate and have more of an open mind to new ideas. It was also noted that in the future consumers would be encouraged to innovate (with smart meters potentially helping).

Incentives

In order to avoid unnecessary costs to consumers, several delegates noted that the RPI-X@20 project should consider ways in which greater focus could be placed on minimising long-term costs - moving away from the current short term focus. The challenge was seen as how to incentivise this. One member noted that greater use of long term financial products would be important. Another questioned how Ofgem would assess what was a 'sensible' decision after the fact.

There were also discussions around the length of the control period and whether this needed to be extended. There were questions about how credible commitments could be made beyond one period and whether longer periods were consistent with the need for the framework to be flexible. It was noted that longer term planning could be introduced as part of a five year price control.

Intergenerational issues were also seen as an important issue and how these should be balanced. It was suggested that the project will need to consider whether it is desirable that costs are incurred now in return for benefits to consumers in the longer term e.g. 20/30 years time.

Some indicated they believed the incentive rates for electricity distribution price control 4 (DPCR4) were insufficient to be fully successful in encouraging DG. It was also highlighted that policies in relation to feed-in tariffs (FITs) will require time to implement and embed.

One delegate suggested that there should be specific incentives and disincentives related to employee safety and training. There may also be a need to incentivise particular recruitment strategies (e.g. bringing in required skills). It was noted that thinking in five year increments didn't lend itself to this.

It was noted that networks needed to have incentives that were consistent with encouraging less units to flow through the network. Changes to the controls to delink revenue from throughput were meeting this need.

Focus on outputs

The idea of focusing on outputs was highlighted as an important step in the right direction for dealing with long term investments and innovation. In particular it was noted that networks respond well if they are given a set of objectives and rewards for delivering. One delegate also noted that it may help deal with the fact that capital forecasts are always 'guesstimates'.

However, due to the difficulty in predicting outputs over the long term, it was suggested that they must be as flexible as possible. There was a question as to whether it should be behaviour or processes that should be rewarded rather than outcomes themselves, particularly where outcomes would be delivered a long time in the future.

It was suggested that outputs would be easier to predict in terms of transmission but may be more difficult for distribution. There were also warnings of the need to consider potential unintended consequences when defining outputs and designing incentives around them, with losses cited as an example to learn from.

If outputs were to be used, some participants would like to see networks being given more freedom and being allowed to retain any profits so long as their outputs were achieved. It was believed that this would allow networks to achieve their targets in the most efficient manner and would encourage innovation.

As an aside one group discussed whether distribution networks should have responsibility for smart meters and that these should be included in the RAV.

Role of consumers

The point was raised that the question for the RPI-X@20 team should not be 'Do consumers want more engagement?' as this will always be the case. Rather, the team should be asking 'What involvement do they want and how should this be achieved?' where the answer is less clear.

The issue of how best to represent consumers was also raised, with some suggesting that Ofgem is the "advocate" for consumers. There were also questions around how to represent future consumers.

Concerns were raised around the increased level of consumer engagement intended by the review team, and some delegates pointed out that it is Ofgem who is the regulator, not the consumer. Furthermore, the education needed to engage consumers was seen as a significant barrier and parties noted that there was no clear representative to act as a voice for consumers. A question was raised as to what consumer reps could add over and above Ofgem. It was suggested that an appropriate balance between networks, Ofgem and the consumer needs to be struck. It was noted that smart meters may hook people's interest in the future.

However, some delegates suggested that there is a need for closer relationships with consumers and that Ofgem does need to help facilitate this. Others felt that, although this may be possible in relation to transmission networks, the same may not be said for distribution networks due to there being large differences across the country and consumers not necessarily being sufficiently knowledgeable in the industry. In this case, it was suggested by some that RPI-X@20 must accept this lack of understanding and find some way to work around it.

It was noted that non-technical summaries could be provided, on both the RPI-X@20 review and in relation to future price reviews. There could be varying levels of these, for example of the 'man on the street', for workers and for politicians.

One group suggested that Ofgem should not limit too much what they decide consumers care about. They do care about renewables, nuclear and delivery of low carbon economy. This should be a key hook of the review that wider public will be interested in. The outcomes or outputs are what 'man on the street' needs to understand, whereas other parties (e.g. energy users) are interested in the regulatory framework as well. It was also suggested that reviews needed to be focused on the impact that they have on users of the systems and on consumers, with more transparency on the outcomes.

One delegate highlighted their experience of the stakeholder workshops introduced at DPCR5 to discuss network business plans. They noted that while it was seen as a good idea, they were poorly attended by suppliers.

Some participants suggested that the review is taking the least ambitious approach in terms of consumer engagement, whereas others suggested that the review is too ambitious in this aspect.

Right of appeal

Discussions around consumer right of appeal highlighted concerns regarding the increased risk this may present to networks. Some delegates suggested that this could cause networks to focus on how to cope best with a Competition Commission reference, instead of focusing on Ofgem's review. This view revolved around the feeling that opening the right of appeal would result in regular referrals to the Competition Commission and this would then inform expectations.

There was a suggestion that the ability of consumers to challenge the final settlement may create incentives to engage.

There was also discussion around what a right of appeal might look like, who would be given it and on what basis an appeal could be made. It was suggested that the merits of any proposal on right of appeal for third parties could only be assessed when the specifics of the model were understood.

Simplicity

Alongside recognition of points raised by the Consumer Panel, there was a plea from some participants for more simplicity to mitigate risks of regulatory capture and reduce barriers that complexities may pose for other parties beyond shippers, suppliers, networks and Ofgem e.g. consumers who may want to take part in the price control process.

A multi-tiered approach was suggested, with differing levels of detail being included in reports to target the various stakeholders involved who have differing interests and levels of understanding.

Competitive Pressures

Those in attendance were generally unsure of the scope of the tendering procedure which is being suggested by Ofgem. Some were in agreement that the majority of the networks should not be subject to a tendering process but that it may be a good idea in one-off, extreme cases (e.g. new long distance connections).

It was suggested by others that any tenders which were introduced should have a high level of transparency, in which case the threat of a tendering process could be a useful tool for Ofgem.

Some members were not in support of introducing competitive pressures and challenged Ofgem to come up with evidence of where it had brought benefits. It was noted by other attendees however that nobody was suggesting that competitive tendering would deliver innovation. Others did however present the belief that the competitive pressures working paper was insufficiently ambitious in this respect.

The future role and outlook for gas

There was a perception amongst some that the RPI-X@20 review appears to be concentrating on the future of the electricity market, and is not addressing the gas market in equal measure. Several delegates suggested that the challenges may be greater in electricity but it was noted by many that there are issues to be addressed in gas too. These included gas storage, the impact of LNG and biogas, and the potential impact of new technologies on gas networks.

There was a call for more attention to be given to the future role and outlook for gas – beyond carbon footprint alone – both in the context of the review but also as a general point extending in relevance beyond Ofgem.

One challenging area in gas that was raised was the need for policies to be aligned and complementary, given some forecasts suggesting declining gas demand. For example, one member cited that government forecasts for domestic gas use were zero by 2050. Meanwhile, there are measures to provide carbon credits to parties that switch to gas.

It was suggested that there was a danger that potential change in the future outlook for gas could be overestimated, highlighting a need for some "realism to be injected" into debates based, where possible, on real quantified estimates. The point was made that the focus should be the next 20 years, not speculation about extreme scenarios for the next 100 years.

Some were of the view that future developments could involve both a need to extend existing asset lives and a need to manage a process of depletion which may be gradual rather than "cliff edge". Reasons put forward included the role that gas could play in a world of intermittency in generation of electricity, a "vast existing stock" of gas connections which sit outside the scope of policies relating to zero carbon homes by 2016, and the potential for bio-gas and carbon capture and storage (CCS).

A cautionary point was made that any decline in supply needs to be signalled in sufficient time to enable switching decisions. The importance of mitigating any potential risks of inefficient investment resulting from changes in the demand for gas was also highlighted. This was due to the higher proportion of a consumer's bills that gas services account for compared to electricity.

While domestic use of gas was expected to decline in the future, one member highlighted that infrastructure to transport gas will still be required due to international treaties allowing the through carriage of gas through the GB network.

Apart from the need for Ofgem to understand likely future scenarios for gas when regulating the industry (e.g. reviewing investment plans) there was limited discussion of the need for a different regulatory treatment or different solutions in gas compared to electricity. It was noted that the wider regulatory framework is different in gas; for example there are incentives on long-term behaviour through capacity auctions. These provide lessons on how regimes that include a long-term focus can get very complicated. It was also emphasised that the different histories of the regulatory frameworks in gas and electricity should be taken into account when designing frameworks for the future.

Some were of the view that a decision on how best to optimise between gas and electricity over the long term sat at the top of a hierarchy and that more coordination was needed across gas and electricity and distribution and transmission. Some

participants saw addressing the incentives to connect renewables (e.g. concerns that current arrangements may not adequately encourage bio-gas) and encouraging broad ranging innovation as key regulatory issues to be addressed lower down this hierarchy.

Some delegates suggested that Government and Ofgem could present a more positive outlook for gas in order to help gas companies to gain more investment.

When considering whether the regulatory frameworks for gas and electricity should be the same, one delegate noted that there were more differences between companies in one sector than across sectors. It felt like the frameworks should be broadly the same.

Role of Ofgem

There was a call for a clear economic framework, against which decisions can be made, which drives down costs without blocking off other developments. As part of this, it should be recognised that investment is happening now and the process for asset replacement takes time (including learning time for Ofgem).

There was also a discussion about how Ofgem should assess network plans and delivery, particularly around how much detail they should go into and what the frequency of interface with networks should be. It was suggested that Ofgem should identify its role and stick to it.

Other issues

It was suggested that Ofgem should actively seek greater integration of regulatory frameworks with N. Ireland and Ireland, eventually leading to greater integration with the rest of Europe. This discussion highlighted that the countries involved stood to gain from working together, with the drawback of having to adapt in order to become a European market.

In one group it was suggested that regulation should not extend to more intervention on pensions. It was emphasised that networks should be left to manage these.