RPI-X@20 Stakeholder roundtable discussion on Emerging Thinking
Summary of proceedings

Venue: Ofgem offices, Third floor, Cornerstone, 107 West Regent Street, Glasgow, G2 2BA

Date: 11 March 2010

RPI-X@20 is Ofgem's detailed review of energy network regulation. The recommendations of the review will be reported to the Ofgem Authority in summer 2010.

On the back of publishing our Emerging Thinking document[1] that set out, for consultation, a potential new regulatory framework, two stakeholder events were held in March 2010: a workshop was held on 5th March in London and a roundtable discussion with stakeholders was held in Glasgow on 11th March.

The Glasgow roundtable was split into two parts. First, Ofgem delivered a presentation that provided an overview of the key points from Emerging Thinking. The slides for this presentation are the same as those presented at the 5th March London workshop[2].

Following this presentation, a discussion was held on specific aspects of the potential new regulatory framework supported by slides delivered at the 5 March London workshop[3]. The topics discussed were:

- **Discussion topic 1: Embedding financeability in a new regulatory framework** – delegates discussed aspects of the straw man set out in our parallel consultation document.
- **Discussion topic 2: Better regulation** – Proportional regulation, simplicity, and accountability – encompassing effective engagement and third party right to challenge – were discussed as part of this topic.
- **Discussion topic 3: A longer term outcomes-led framework** – this discussion focused on output measures, potential new business plan requirements and the length of the price control period.
- **Discussion topic 4: Delivering value for money in the longer term** – emerging thinking on a greater role for competition and tendering formed the focus of these discussions.

A summary of the key themes emerging from these discussions is presented below. These summaries have been provided to allow a wider audience to review and consider the issues emerging on the day. If stakeholders have any comments or questions

---

[1] Available at the following link:
http://www.ofgem.gov.uk/Networks/rpix20/publications/CD/Documents1/emerging%20thinking.pdf

[2] These slides can be found at the following link:
http://www.ofgem.gov.uk/NETWORKS/RPIX20/PUBLICATIONS/PRESENTATIONS/Documents1/Intro%20slides.pdf

[3] These slides can be found at the following link:
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=50&refer=NETWORKS/RPIX20/PUBLICATIONS/PRESENTATIONS

regarding the summaries below or the workshop more generally, please contact the RPI-X@20 team at RPI-X20@ofgem.gov.uk.

Embedding financeability in a new regulatory framework

Delegates were encouraged to consider the following questions:

1. Is there merit in providing differentiated allowed rates of return for companies within a given class/sector?
2. How should we strike an appropriate balance between the interests of current and future consumers in determining the approach to capitalisation and depreciation? What are the potential implications of changing our approach on asset lives?
3. What is an appropriate way of assessing financeability in future price controls? What are the potential implications of moving away from cash flow ratios typically used by Ratings Agencies?
4. Is the approach taken in DPCR5 of using return on regulatory equity (RoRE) analysis to calibrate the regulatory package appropriate going forward?[4]

Differentiated allowed rates of return

A question was raised at the opening of these discussions as to what the expected outcome would be for an inefficient network operator under the straw man. In response it was emphasised that, as part of any future regulatory framework, Ofgem is seeking to ensure that those companies that deliver for consumers would be appropriately rewarded, whilst those that do not would be exposed to credible downside. It was suggested that this might mean that there is a wider spread of returns for network operators than currently, which could result in more merger and acquisition activity. On this basis, delegates saw the extent to which the bottom of the range of allowed rates of return should vary as a key issue being explored.

Some delegates indicated they could see merit in the idea of differentiating returns on this basis. There was, however, a perception this would mark a significant shift from the current approach and could lead to potentially greater risks of challenge for Ofgem if underpinned by spurious accuracy.

The group also discussed whether the allowed return should be set on a company-specific basis rather than a sector-specific one. There was no clear consensus on this but some participants felt that this might be a case of 'spurious accuracy'.

Approach to capitalisation, depreciation, and asset lives

With respect to ensuring an appropriate balance is struck between the interests of current and future consumers in determining approaches to capitalisation and depreciation, delegates noted trade-offs would always exist in relation to intergenerational equity, reinforcing the need for a general re-opener.

A general message emerged from delegates there was a risk of "devil in the detail" in relation to policies on depreciation. In particular, it was questioned how asset lives would be calculated, though it was acknowledged that assumptions are already made in this area. It was also questioned whether lengthening the economic life may lead to

---

[4] Further details on the use of RORE in DPCR5 can be found in the Electricity Distribution Price Control Review Final Proposals document, available: http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/DPCR5/Documents1/FP_1_Core%20document%20SS%20FINAL.pdf

perverse outcomes with respect to intergenerational equity and whether potential changes over time in the customer base may mean depreciation profiling should be considered.

There was a discussion on issues relating to the speed of money. While delegates could see the logic behind seeking to address trade-offs between opex and capex as part of DPCR5, it was not clear to some delegates how a link could be drawn in this context to the speed of money. The question was raised as to whether other alternatives would be identified as part of RPI-X@20. It was also questioned how efficiency savings would be allowed to be recovered in the context of a potential partially extended control. One delegate suggested it may be worthwhile to explore why a 5 year opex rollover incentive was not applied in gas distribution.

Assessing financeability

Concerning the assessment of financeability, it was clarified that cash flow tests would still be undertaken under the straw man but that these might not necessarily be against published requirements by the credit rating agencies.

It was acknowledged by delegates that criticisms have been raised of ratings agencies having a general tendency towards being reactive rather than proactive. It was further noted there may be risks associated with expecting ratings agencies to evolve from the way they have traditionally tended to operate. In response, it was noted that it was reasonable to expect that ratings agencies would respond to changes in the regulatory framework, particularly if placed on a longer-term footing.

Despite these criticisms, a number of delegates were strongly against any lessening in emphasis placed upon ratings agencies. The reliance placed by the market and financiers on these agencies and a lack of a credible alternative were cited as key reasons for this opposition. One delegate also questioned whether there was a tension between recent proposals on ring-fencing that appeared to recognise the benefits ratings agencies had to offer, though it was emphasised that the distinction needed to be made between uses in calibration of allowed revenues as opposed to use in other contexts.

The ongoing usefulness of accelerated depreciation as a rebalancing tool was briefly discussed where one delegate questioned its usefulness when set against a backdrop of large investments potentially requiring increasingly significant tweaks.

Interactions with the length of the control

Delegates highlighted the importance of considering interactions between aspects of the financeability straw man and ideas on partial lengthening of regulatory commitments. The point was made that even with longer-term commitments some measures would still be required to ensure financeability. This was supported by a view that a "cliff edge" would still exist. Drawing a link to an earlier point, delegates questioned whether any move away from credit ratios typically used by ratings agencies may limit the options of measures available for use in this context. Another delegate also made the point that the downsides of re-openers from a supplier's perspective need to be borne in mind.

The importance of Ofgem sticking to longer-term commitments, including where this involves upsides, was emphasised. It was further noted this may require a change in mindset by Ofgem. It was reiterated that ad hoc ex post adjustments would not be made by Ofgem.

Potential risks

A general point was made that it was "crucial markets were not upset" and that potentially significant implications of ideas on financeability, magnified by significant competition for investment, can not be lost sight of. One delegate took this a step further, noting they did not see anything in the proposed regulatory framework and straw man that would deliver investor confidence and that retention of the RAV alone would not necessarily deliver this confidence. In response it was clarified that the RAV and commitments to a return on the RAV would remain. Delegates also highlighted the following potential risks associated with the straw man:

- Poorer outcomes and more expensive services for customers if parts of the network were to become unfinanceable; and
- Tensions between allowing companies flexibility to decide how best to finance their entity and Ofgem closing off potential options that might be available to them.

In response to a question raised it was clarified that feedback from the financial sector was being sought to inform the development of proposals on financeability.

Better regulation

Delegates highlighted a potential risk of complexity undermining the workability of further developed proposals. They also emphasised the importance of predictability of future price reviews and avoiding surprise changes, particularly when set against a context of long-lived network assets.

Proportional treatment

Delegates indicated they were keen to understand how proportional treatment might work in the event of a change in ownership and, in particular, whether this would trigger reassessment. They were also keen to understand what the implications of joint ownership might be; an issue indicated to require further consideration. The relevance of the current review of merger policy in considering these issues was highlighted.

There was some concern as to whether an appropriate level of commitment to upsides associated with proportional treatment would be delivered, particularly when set against a context of potentially lengthened aspects of the control and potential for the control to be re-opened. The potential for unintended consequences was also highlighted alongside reference made to the losses incentive.

Enhanced engagement and right to challenge

Though some delegates saw the benefits of such a right to challenge in principle, it was largely seen as a "side issue". This was supported by a perception of limited demand. This included a perception of limited demand among consumer groups who were viewed as unlikely to have the capacity required to pursue a challenge. It also included a perception of limited demand from suppliers given that issues driven by factors outside of the price control, such as charging methodologies, would sit outside of scope.

Questions were raised as to how a third party right of challenge would work in practice. This included the question of how a right of challenge would work in the light of the sensitive nature of information provided by companies in the context of a price review. The likelihood of a third party being able to mount a reasonable challenge without access to this material was questioned. A more general point was raised that third parties may not have access to sufficient information to support a challenge extending beyond general disagreement of the decision taken. With reference made to the Beauly-Denny project, it was questioned whether criteria could be defined sufficiently tightly so as to avoid issues sitting outside of the price control (such as planning) being captured.

One delegate indicated they had seen evidence of a positive shift post DPCR5 in terms of active engagement by DNOs.

A longer-term outcomes-led framework

Outputs

While a number of delegates indicated in-principle support for a greater focus on outputs, they also saw a number of practical challenges in seeking to design quality output measures.

In particular, delegates could see challenges in creating meaningful output measures that don't stifle innovation or create perverse incentives, where the illustrative example was raised that we would not want to discourage complaints from being raised nor discourage companies from seeking to avoid the cause of complaints. They also emphasised the need to ensure that, in establishing output measures, this did not lead to "data being collected for data's sake". Potential challenges were also identified in exposing trade-offs when engaging with consumers and reflecting differences in preferences across different consumer groups.

With respect to proposed output categories, it was clarified that outputs developed as part of DPCR5 – noted as challenging to develop given heterogeneity across companies – represented only an initial starting point. It was also clarified that the extent to which outputs might replace incentives or become minimum targets would depend on the nature of the output.

There was a call from one delegate for an output measure extending beyond obligations imposed by the HSE on network companies – for instance capturing near misses and accidents – to be considered. There was also a call for measures designed to capture social obligations to include training and the number of apprenticeships offered. This was underpinned by a view that outputs need to reflect value being added to the workforce through training.

New business plan requirements

While a number of delegates indicated they could see sense in proposals regarding business plan requirements, they saw a need for greater detail to be provided. Specific questions were raised in relation to how the situation of a number of different scenarios being proposed by network companies would be dealt with and whether proposals could pose difficulties in benchmarking.

It was recognised that Ofgem would, in effect, have to endorse a business plan provided there was comfort with the quality of the methodology and engagement supporting the plan, though it was emphasised Ofgem would also need to be comfortable that the needs of all consumers (including future consumers) were reflected.

The question was raised as to what Ofgem was intending to do with the information companies sourced in engaging with customers. In response, it was noted that the more relevant issue was the use companies made of that information to inform their business plan.

Charging methodologies

One delegate indicated they could see a potential tension between proposals on charging methodologies and other governance arrangements. This was supported by a view that Ofgem would, in effect, become "judge and jury". It was noted that proposals were primarily motivated by bringing thought processes together at the time of a price review and that it was recognised these ideas require further development.

Delivering value for money in the longer term

Tendering

It was clarified that the motivation behind a tendering tool extends beyond potential value in surfacing the cheapest option to wider benefits it could deliver as a tool for market testing not only costs but also the quality of the proposed solution. While there was support for market testing being the "right route to go down" in pursuit of efficiency, there was some scepticism among delegates as to the potential benefits further tendering could deliver when set against a context of the amount of tendering already undertaken by companies. Some delegates envisaged that the level of tendering would only increase in the future, driven by constraints in sufficiently qualified staff.

Delegates highlighted the importance of carefully considering triggers and potential risks tendering could pose to training up the work force. They also highlighted the importance of ensuring there is expertise and competence to deliver so as to avoid tendering leading to unnecessary delays. One delegate saw placing an obligation on bidders to source suitably qualified workers as a potential way forward in addressing this issue.

There was a call to carefully consider interactions between the tender process and charging so as to avoid unnecessary re-opening of charges once they have been fixed.