RPI-X@20

Emerging Thinking stakeholder workshop

Summary of issues discussed

5 March 2010

Ofgem Offices, 9 Millbank, London

The RPI-X@20 London stakeholder workshop on our Emerging Thinking consultation provided interested parties with a high level overview of our Emerging Thinking consultation document. Ofgem also provided an update of how the project is going to be progressed before Ofgem makes its final recommendations to the Gas and Electricity Markets Authority (GEMA) in summer 2010.

Participants were split into break out groups based around four key areas of the review:

1) Embedding financeability in a new regulatory framework

2) Better regulation
    - Effective engagement
    - Third party right to challenge
    - Accountability
    - Proportionate regulation
    - Simplicity

3) A longer term outcomes-led framework
    - Outputs
    - Improved business plans
    - Length of the price control period

4) Delivering value for money in the longer term
    - Longer term efficiency
    - Length of the price control period
    - Incentives for efficient delivery
    - Innovation stimulus
    - A greater role for competition

The purpose of each group was to allow an exchange of views between interested parties over the issues raised in the Emerging Thinking document. To facilitate an exchange of views on each topic, a short presentation was given by a member of the RPI-X@20 team and the groups were also given a set of guiding questions. All the presentations at the workshop can be found at:
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=50&refer=Networks/rpix20/publications/Presentations

A summary of the discussions that took place during the breakout sessions is provided below.

Embedding financeability in a new regulatory framework

Differentiated allowed rates of return

The general view of delegates was that Ofgem needs to be clearer on the types of risks that are remunerated through the allowed return and the risks accommodated in other areas of the price control. Delegates generally agreed that differentiated allowed rates of return could be appropriate if many different types of risk are remunerated through it.

One delegate said we should be asking "how do we allow for differing risks between companies in the price control?"

Delegates also made the following points:

- There should be different remuneration between companies of different sizes. That is, smaller companies find it harder and/or more expensive to access financing than larger companies and should be remunerated for that extra risk.
- There is little merit in moving away from the Capital Asset Pricing Model (CAPM) when assessing the cost of equity as it is a well established approach.
- There could be merit in allowing companies within a sector to choose a "package" of risks from the price control with corresponding rates of return.
- There would likely be implications for the rate of return in a longer term price control as companies would have a greater exposure to volatility in the capital markets.
- Companies assess risk differently from Ofgem i.e. a company who is comfortable with risk will opt for a higher rate of return while risk-averse companies may accept a lower return.
- It is a nice idea to have differing allowed rates of return but it would be difficult to implement in practice.
- Ofgem may need to have an ex-post adjustment to make differential rates of return work. This could mean an assessment of efficient and inefficient spending would be required – which could be complicated.

Assessing financeability and potentially moving away from methodologies typically used by Rating's Agencies

The majority of the delegates were opposed to moving away from the Rating's Agencies methodologies on concept and practicality grounds.
The following points were made:

- One delegate said that Ofgem's recently published "Review of the Ring Fence Conditions in Network Operator Licences" consultation had partly answered this question as the licence specifies the requirement for companies to hold an investment grade credit rating.

- Having a credit rating is the only way to access cheap debt. Hence, if Ofgem were to change their methodology the overall cost of capital for companies could rise.

- The City could be comfortable with a move away from the Rating's Agencies methodology. However, another delegate said that most debt investors are comfortable with Rating's Agencies and that a change away could be negative.

- A reliance on the Rating's Agencies remains a necessity even though questions remain about their methodology.

Capitalisation and depreciation

Many delegates felt that Ofgem's approach to capitalisation in DPCR5 (fixed percentage of total expenditure) would not be compatible with a change in the regulatory depreciation rate to reflect the economic life of the assets - as the Regulatory Asset Value (RAV) would not reflect actual assets.

Delegates made the following other points:

- The total expenditure (totex) – fast money/slow money approach would not be required in gas distribution as there is a greater clarity in the split between opex and capex compared with other sectors.

- One delegate asked if there is any merit in obtaining a company and Ofgem view on regulatory asset lives.

- The depreciation rate should reflect the risk of "stranded assets," i.e. the return of capital should be faster than the useful life of the asset in sectors where there is a greater risk of stranding.

Return on regulatory equity

Many delegates agreed that "calibrating the package" is an appropriate approach in a price control but were unsure about the validity of Return on Regulatory Equity (RoRE). The following other points were made:

- Many regulated companies still don't understand how RoRE is calculated and/or what it is used for.

- Why are returns to equity being considered when Ofgem is setting an ex-ante return on total capital?

Many respondents could not understand the use of RoRE in DPCR5, asking whether it was genuinely used to calibrate the package or was it a way of making the perceived low headline Weighted Average Cost of Capital (WACC) more attractive.

Better regulation

Enhanced engagement

Delegates were broadly supportive of the enhanced engagement proposals in Emerging Thinking. In particular, there was support for the idea of networks seeking 'sign off' of their business plans with end users as this would represent good business practice. Delegates agreed that Ofgem should not prescribe who network companies seek this 'sign off' from. This should be left for network companies to determine.
For network/consumer engagement to be effective, several delegates highlighted that Ofgem would need to provide clarity on its expectations for the process. Several delegates noted that the enhanced engagement process will require a change in the mindset of managers, who traditionally focus on shareholders rather than consumers.

Delegates did not think specific incentives were needed to encourage network/consumer engagement. A couple of delegates thought that the potential to reduce Ofgem's scrutiny of network business plans would be sufficient to encourage proactive engagement.

Delegates discussed the experience of network/consumer engagement during DPCR5. It was noted that while some DNOs had engaged with their consumers in line with expectations, others had not. One delegate highlighted the lack of potential 'comeback' by Ofgem as a reason why the experience had been mixed at DPCR5.

One delegate highlighted that the enhanced engagement process would differ for transmission companies. Network companies were seen as far away from end consumer and, as such, engagement in transmission would be different to distribution.

Complementary enhanced engagement, led by Ofgem, was seen as positive by all of the delegates, however, it was highlighted that for it to be taken seriously, the burden of proof would need to shift such that Ofgem becomes more transparent, particularly where its views differ to those of network companies who had engaged with their consumers.

One delegate discussed how the price control fora could work. They were seen as:

- Being used as part of the review process, before key decisions are made;
- An avenue to provide information on business plans; and
- A forum to judge how stakeholders feel about the business plans (after networks own engagement with their consumers)

Several delegates highlighted that while there would be some role for suppliers in enhanced engagement, they should not be the central party that Ofgem and network companies should seek to engage with.

Right to challenge

There was a strong view from delegates that a right to challenge mechanism would lead to frivolous and strategic challenges by third parties.

One delegate noted that even if third parties faced the costs associated with launching a challenge, this would be unlikely to prevent strategic challenges by well resourced groups. Whatever the internal costs were, for some parties, it would not be a deterrent because the benefits they would realise by delaying price rises would outweigh the costs of the challenge. Another delegate noted that consumer representatives may be deterred from making frivolous challenges due to the significant internal costs that would result.

A number of delegates were concerned that Ofgem may not be sufficiently independent to play the role of the gatekeeper in determining whether to refer a challenge to the Competition Commission (CC). The importance of creating clear guidelines for Ofgem, were it to have such a role, was emphasised as a way of mitigating this risk.

Several delegates highlighted that a third party right of challenge could negatively alter the mindset of network companies as they would focus their attention on the CC rather than Ofgem. Concern was also raised that unlike Ofgem there was less scope for the CC to be held to account for decisions that it takes on cases that are referred to it.

Several delegates highlighted a concern that introducing a third party right to challenge could freeze investment decisions by network companies at a time when significant amounts of investment are needed. The example BT's experience was cited here.

One delegate felt that the enhanced engagement process would be sufficient to encourage decision making by network companies and Ofgem that is in line with consumer interest – without the need for having a right to challenge.

One delegate thought Ofgem should consider the merits of a challenge being sent to the CAT rather than the CC, while another raised concern that the process could be used to launch challenges based on other areas of concern such as the structure of charges.

Differential treatment of network companies

One delegated thought that differential treatment already implicitly exists, with some companies business plans expected to get a greater share of Ofgem's time at the price control review. However, the delegate noted that Ofgem could go further by making available additional rewards for companies that submit well justified business plans.

Delegates broadly agreed that targeting of Ofgem's resource was a good idea (with the HSE approach highlighted as an example). However, several delegates emphasised that Ofgem would need to set out firm criteria for the application of differential treatment. Several delegates suggested the development of a balanced scorecard to facilitate this.

If such a score card were developed Ofgem would need to be clear and transparent about how it would work, how rewards and penalties would be determined and would need to consider publishing comparative information on companies.

One delegate queried how such an approach would link to Ofgem's policy on mergers.

Simplicity

One delegate liked the idea of more simplicity in the process but wondered how possible this was. A couple of delegates were not convinced that simplicity should be a significant goal for the RPI-X@20 project, highlighting that good working should not be sacrificed to achieve it. Rather transparency was seen as more important, particularly if there is a desire to encourage greater consumer engagement.

A longer term outcomes-led framework

Outcomes and Outputs

There was a general feeling that the outcomes put forward by Ofgem are fair and that delegates support our principles. However, it was agreed that the devil will be in the detail in ensuring that our outputs work. There was a view that six output categories could be used for the case of distribution but would be harder to define in transmission.

Delegates believed that there were three fundamental issues with basing the regulatory framework on the assessment of outputs. These were alignment and definition, administration and reporting and the impact on allowed revenue.

Some delegates were concerned that an output based framework might include an output linked to the utilisation of assets which may be a step change in transmission. They claimed that three or four funding mechanisms may need to be in place to encourage investment if this was implemented.

Some delegates were concerned that outputs may lock networks into certain paths and lead to micro-management. In addition this may lead to more resource intensive and costly regulation. On the other hand, there was a belief that the higher level the outputs were, the more robust and adaptable they would be.

Delegates felt that some outputs may be less relevant than others in certain sectors. There may also be a conflict between outputs, for example environmental and social outputs. Some delegates asked whether environmental targets would simply be the networks own carbon footprint or more far reaching such as connecting renewables, etc?

A number of delegates believed that if networks can select which of the outputs are most relevant/important, the price control may be agreed upon different things over time and across sectors. This could increase the challenge of transparency and communication.

Delegates believed that in order to meet certain outcomes, legislation and structure beyond that of Ofgem would play an important role and should be understood. Ofgem suggested that it should be networks who communicate with wider stakeholders. The example of locational charging was raised to show that there may be a conflict between more cost reflective charging and the viability of connections and social costs.

Uncertainty

Delegates thought that flexibility would be needed in output measures to deal with uncertainty. They felt that a move to a longer term control could increase uncertainty further. There were concerns that to make the framework more certain, Ofgem could slip into more intermediate outputs defeating the object of an outcomes-led framework.

Discussion highlighted a perceived conflict between certainty and flexibility. Delegates questioned how Ofgem could create a flexible regulatory framework through certain, committed output measures. This led some delegates to voice the opinion that more certain outputs can be locked into the longer term while others are more uncertain and must be looked at in the short term to maintain flexibility.

License condition issues

Delegates believed that there may be clashes between outputs and license conditions. An example was raised relating to Energy Service Companies (ESCos). Some claimed that license conditions would not allow a network operator to play an ESCos role. One delegate said that facilitation of ESCos could reverse break up of network company supply chains. Some delegates felt that one way to limit these clashes may be to 'loosen the shackles' that the license obligations place on the companies. There were differing opinions as to whether this would be a good way to facilitate change or should be avoided.

Length of the price control

Some delegates voiced the opinion that a longer term price control would lead to more uncertainty as more will change over this horizon. Conversely, others believed that investment must be made now to meet future targets and that long term planning is needed. However, while a price control should encourage this, flexibility must be built in.

Some suggested that one solution may be frequent controls but with longer term output measures although it was questioned how Ofgem would manage this. Delegates believed that clarity and understanding are the most important parameters to encourage longer term thinking. Some thought that there is currently insufficient clarity to encourage this.

Delegates raised the point that Ofgem cannot 'bind its successors', i.e. limit the tools available at future price control reviews. This can increase regulatory risk. It was believed that this is exacerbated by Ofgem turnover between controls leading to a lack of consistency. Therefore, delegates felt that the commitment and consistency required by Ofgem for companies to plan longer term may not exist.

Many delegates suggested that networks would be happy to take on a greater level of risk if it led to proportionately higher returns. Some voiced the opinion that the current WACC is too low to encourage this level of risk taking.

New business plans

Delegates mentioned that previous price controls (DPCR4 and DPCR5) had required network companies to submit alternative plans and provide 10 year forecasts. They believed that after a significant amount of resource and effort, Ofgem hardly used this information to set the level of the price control. There was a similar issue with stakeholder informed business plans. Because of this, delegates voiced concerns with new proposals for business plans which would present numerous delivery options and longer term planning. They believed that Ofgem must think carefully about how this extra information will be used.

Delegates believed that any stakeholder engagement which is used for the business plan must be presented and judged objectively. It can then be used to develop the 'meat' of the price control.

Delivering value for money in the longer term

Value for money

In the course of discussions, which focused in particular on innovation, it was emphasised that Ofgem needs to be clear on what is meant by value for money and to be clear on who decides what value for money is for consumers. It was noted that the focus on the longer term and a focus on engagement would help.

An innovation stimulus

There was some uncertainty among delegates as to what was meant by innovation and, in particular, whether we had in mind steps to innovate on technology likely to take considerable time and investment, or process or asset build innovation, highlighting for some that it would be helpful for the particular focus to be articulated by Ofgem. Delegates were, in general, welcoming of the idea of establishing an innovation stimulus. It was mentioned that a stimulus could provide a useful "stop gap" that would help network companies make the most of the near term to prepare for medium term challenges such as contributing to the achievement of 2020 targets. The point was also made that potential effects of innovation may not be captured within business plans.

Questions were raised as to how a stimulus would work. These included the question of how a situation would be dealt with where innovation fails and in particular how this situation sat with a focus on value for money. It was recognised that a "filter" process should, however, serve to limit these instances to failure which is not a symptom of poor management. On the other hand, it was emphasised that where failure led to learning this should be seen as a positive success. They also included the question of how issues related to intellectual property would be dealt with while at the same time facilitating sector wide responses and the spread of best practice.

Delegates emphasised the importance of carefully considering how benefits and risks would be socialised, highlighting potential risks of cross subsidisation (including from gas to electricity customers) and risks of dis-incentivising participation if early sharing of benefits is required without adequate reward. More generally it was emphasised that it needed to be recognised and accepted that the benefits of the type of innovations being considered would accrue to all users but only some would pay. It was also underlined that innovation could deliver benefits beyond network companies and that these should be taken into account.

Delegates indicated in-principle support for a stimulus that facilitates involvement by non-network parties in trialling innovations, provided this is supported by appropriate contractual arrangements that mitigate potential safety risks. There were questions about how this would work, with discussion around whether and how supply companies could collaborate with their own networks. Underpinned by a perception that a number of customers do not feel they are getting the service they expect coupled with complexities associated with management of operational matters, this underlined for some delegates the need for effective management of projects if placed at the hands of an external party.

It was suggested company responses to the Innovation Funding Incentive (IFI) and other lessons the IFI can offer, including impacts on the cost of operating networks and the quality of information it has delivered, should be taken account of in further developing our ideas. It was, however, highlighted by another delegate that it needed to be recognised the IFI was introduced at a time of less uncertainty and there are questions about whether the amount of money involved is sufficient.

A potential conflict between aggressive competition and collaboration was highlighted, suggesting a potential role for some delegates for league tables to be used in encouraging innovation. It was emphasised that innovation was intrinsically linked to a skilled workforce.

A greater role for competition in delivery

Polarised views emerged in discussions on tendering and it was generally emphasised that Ofgem should not be looking for competition for competition's sake.
Some questioned the extent to which tendering could deliver greater efficiencies, particularly when transaction costs and the need for coordination were taken into account. Delegates questioned how Ofgem was going to be sure that tendering would deliver benefits and lower costs. There were also questions about how the safety of system would be protected. There was a discussion as to why failure to identify efficient 'outsourced' solutions was not apparent in benchmarking analysis. It was also noted that Ofgem needed to avoid telling licence companies how to run their business and a suggestion that there may be merits in looking to league tables on costs as an alternative means of promoting tendering, underpinned by a view that tendering should primarily be driven by managers and shareholders.

Others could see tendering delivering benefits through revealing valuable information on comparative costs. It was noted by one delegate that there was a high degree of tendering by companies already (maintenance on high voltage lines was cited as an example). It was noted by another delegate that there was variable performance in procurement practices across companies and a sense that a culture of tendering tended to improve general efficiency.

However, delegates did, in general, share a view that there would likely be significant downsides to a compulsory outsourcing approach. Ensuring safety and the health of employees were not put at risk was also recognised as important across delegates. It was also noted that retaining specialist skills may be difficult long-term if tendering out is widespread.

Longer term controls

Delegates indicated they saw a hybrid model as providing a reasonable balance between embedding longer term strategies and maintaining appropriate constraints. There was encouragement for Ofgem to consider what activities don't lend themselves to five-years, with training and staff development cited as one example.

Better alignment with timeframes for training was also identified as a potential benefit associated with longer controls.

The point was raised that any lengthening of the control should be reflected in the WACC.