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RPI-X@20

RPI-X@20: Academic workshop on emerging thinking

Introduction from Chairman

Michael Pollitt
Cambridge University

RPI-X@20: Overview of Emerging Thinking

Cloda Jenkins
Head of Regulatory Review

RPI-X@20 Emerging Thinking

Three parallel consultation documents

Core Emerging Thinking	Financeability	Third party right to challenge

- Applies to all four network sectors
- Ideas subject to change as we consider responses to consultation and work up detail
- **Written responses by April 9th 2010**

Potential new framework – Fundamental changes to network regulation

Emerging Thinking to Summer 2010 Recommendations

Winter/Spring
Stakeholder engagement on Emerging Thinking

Spring/summer
Working up detail and stress-testing

Summer
Recommendations to GEMA

Jan 10 | Apr 10 | July 10 | Oct 10 | Jan 11

Winter
Emerging thinking consultation

Spring
Potential working papers and consultant reports

Autumn
Recommendations consultation and decision

2011-2013:
TPCR5 and GDPCR2 reviews

RPI-X was not designed for sustainable era

Stakeholders have suggested existing frameworks have led to:

- Networks focused on 5 year price cycles
- Networks focused on Ofgem not their customers
- Limited consideration of innovation and 'how best to deliver'
- Potentially limited appetite for risk
- Limited focus on 'cross-sectoral' interactions

Meeting future challenges and managing uncertainty requires:

- Long-term focus on value for money
- Innovation
- Optionality and flexibility
- Working with others to identify best delivery solutions
- Understanding and responding to needs of existing and future consumers

➢ Mismatch between what we have and what we need?

A new regulatory framework is needed?

Changes from the existing framework

What would remain the same?

Constraint on revenue set upfront	Building blocks approach, including return on regulatory asset value	Rewards for efficient delivery

Network companies who deliver efficiently will remain financeable

What could change? <u>How</u> price control is set

Encourage monopoly networks to be more proactive:

- Play fuller role in facilitating delivery of sustainable energy sector
  - Provide value for money for existing and future consumers

Proposed new regulatory framework

Enhanced engagement between network companies and their 'consumers'

Ofgem engagement with stakeholders

Delivering outputs at centre of framework

Efficient delivery for long term

Incentives on: Output delivery, value for money, working with others

Longer term focus

Innovation stimulus	Competition in delivery	Proportionate treatment	Business plans	Charging links

Reward responding to and anticipating consumer needs

Energy service companies
Non discriminatory access terms

Working with others
Aligned incentives

- Considering whether to allow third parties a right to challenge
- Efficient delivery financeable; no bail out for inefficient companies

Framework the same for all network sectors – variation in how applied

Delivering a sustainable energy sector – focus on what needs to be delivered

Play a fuller role in facilitating delivery of a sustainable energy sector

Environmental targets	Network service connections	Customer satisfaction	Safety	Reliability	Social obligations

Respond to current demands and anticipate future needs

- **Output measures in each category determined at price control reviews**
- **Rewards for delivery; penalties for non-delivery**

‘Allowed revenue’ linked to outputs	Enhanced engagement at heart of ‘what’ to deliver	Need well-justified case on how best to deliver	Delivery performance impacts on future reviews	Mix of financial and reputational incentives

‘Traffic light indicators’ potentially monitored and published

Delivering at value for money – efficient delivery over long term

Retain focus on efficiency incentives

But shift in perception of what we mean by 'efficiency'

Long term

Limit biases between opex/capex

Cost savings but not at expense of delivery

Innovation (technical and commercial)

Network services NOT network assets

Different approaches needed to assess efficient costs and incentivise further efficiencies

Potential move away from focus on five-year control

Focus on longer term across framework

- Longer term business plans
- Longer term outputs

Partial lengthening of price control period:

- Some elements of the control committed to for longer
- Potential indexation of other elements

Regular monitoring of outputs

- Allow us to have a better understanding of potential risks to delivery

Adaptation

- Provisions will be included to reopen aspects of the control
- It is also important that the framework can adapt to changing circumstances

Embedding financeability in the framework

We are seeking to design clear, transparent principles for ensuring companies earn appropriate returns on their RAV but not bail out inefficient companies

- Straw-man proposal set out for embedding our financing duty in the regulatory framework

Key aspects

Allowed return should reflect the riskiness of revenue/cost streams

A measure to monitor performance and returns

Depreciation modelled on economic basis

Clear principles to determine appropriate capitalisation policy

Continue to assess the expected financial health of efficient company

Next steps

Emerging Thinking consultation and stakeholder engagement period

January 20th to April 9th 2010

Final recommendations to GEMA – Summer 2010

Consultation period – Autumn 2010

Decision – Autumn 2010

Implementation

Transmission Price Control Review 5 (TPCR5) – April 2013

Gas Distribution Price Control 2 (GDPCR2) – April 2013

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The new regulatory framework will encourage:

- **Innovation on energy networks**
- **Delivery of a sectoral solution to delivery of a low carbon economy.**

Iain Morgan
Senior Regulatory Economist
Respondent: Goran Strbac,
Imperial College, London

Need for greater innovation

Energy industry stands at a cross roads

Future challenges and opportunities likely to require significant innovation to deliver at best value

- Reduced demand/ energy efficiency
- Back-up generation for renewables
- Ageing assets
- Connection of new nuclear, gas and CCS generation
- Electric vehicles
- Active demand management
- Demand from Combined Heat and Power
- Potential gas hub for Europe

New regulatory framework and innovation

Outputs

Rewards for delivery without specifying how to deliver

Business plans

Different delivery methods presented by network company

Longer price controls

Regulatory certainty over longer time horizon

Tendering within toolkit

Way of opening up the market to other skills/better solutions

Effective engagement

Greater access to third party views

Innovation stimulus

For time limited period – all networks plus third parties

A specific innovation stimulus

An outputs focused regime with appropriately designed incentives and enhanced competitive pressures should encourage networks to innovate to deliver defined outputs effectively

Barriers to innovation to facilitate a sustainable energy sector

- Benefits may accrue to a range of parties
- Potentially significant upfront costs
- Long term private cost to networks of not innovating may not be significant
- Networks do not face a significant carbon price

In the interim a cross-sectoral, time limited innovation stimulus open to a range of parties may be needed

➢ Stimulus would build on the Low Carbon Networks Fund

➢ **Would be introduced at the next round of price reviews for transmission and gas distribution**

➢ **Electricity DNOs have the opportunity to obtain funding through the LCNF**

The new regulatory framework will ensure that energy networks and Ofgem, focus on the needs of consumers and other stakeholders.

Cloda Jenkins Head of Regulatory Review

Respondent: Jon Stern, City University, London

Enhanced engagement: why we need it and what it involves

Important that we understand consumers' interests

Sustainable energy challenges → Likely to lead to increased cost and greater uncertainty

Enhanced engagement effective where:

- Network companies recognise role in communicating with interested parties
- Communication results in a greater understanding of needs
- Communication/understanding of needs informs what to and how to deliver (including recognising need to balance conflicting interests)

What would Ofgem enhanced engagement look like?

Onus remains with network companies to engage widely

Need to encourage effective engagement for example…

Outputs	Business plan	Efficiency incentives
Design Joint outputs	Demonstrate effective engagement	Find better solutions

To complement network engagement, our approach could be multi-layered

- A price control review forum for open discussion
- Developing existing tools
- Making better use of existing fora
- Making information more accessible

There may be merit in including Government in any engagement

- This could facilitate better understanding of policy by networks and stakeholders
- Government would not be involved in detailed discussions on policy

Why not more formal approach?

Looked at more formal mechanisms e.g. negotiated settlement

Interests of parties not sufficiently aligned (including with future consumers)

Diversity of consumer needs and interests makes it difficult to develop full understanding

May be possible to have transition to collaborative decisions in future

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The new regulatory framework will encourage competition in delivery, ensuring innovation, value for money and facilitating energy service companies

Cloda Jenkins
Head of Regulatory Review
Respondent: Chris Bolt, PPP Arbiter

A greater role for competition in delivery

Tendering certain aspects of output delivery could deliver benefits through strengthening incentives or facilitating third party involvement:

Expose actual efficient costs	Delivery of quality, innovative solutions at value for money	Present opportunities for mitigating/ diversifying risks

Merit in establishing tendering as part of the regulatory 'toolkit' to drive efficiency where this does not jeopardise timely delivery

- Questions of "whether and how" would be considered on a case-by-case basis, supported by published guideline principles on use of tendering
- We envisage that most aspects of network services will continue to be delivered by existing networks

We also intend to explore use of our ability to revoke network licences and then franchising as potential way forward

Tendering as part of the regulatory tool-kit

Tendering considered as a potential route to encourage network companies to seek long-term efficient solutions for delivering outputs

We could consider the merits of tendering on a case-by-case basis

Potential tendering models (not mutually exclusive)

Network company chooses to tender as part of its procurement strategy	Ofgem requires company to tender particular aspects of plan	Offshore type model run by Ofgem with new licensees

Facilitating competition in energy services

Energy service companies (ESCos) offer broad range of low carbon energy solutions at community level

Ensure the regulatory framework is not a barrier to viable ESCo development

- New framework will encourage networks to provide fair access terms through outputs
- Action may be taken if ESCos cannot gain these terms
- **We may force network companies to lease/sell assets such as distribution wires/ pipes at community level**

The new regulatory framework will provide strong efficiency incentives on network companies for the long term

Iain Morgan
Senior Regulatory Economist
Respondent: Graham Shuttleworth
NERA

Efficient delivery over long term

What incentivises network companies? → Expected return; Credibility and commitment; Risk and downside

Retain focus on efficiency incentives

But shift in perception of what we mean by 'efficiency'

Long term	Limit biases between opex/capex	Cost savings but not at expense of delivery	Innovation (technical and commercial)	Network services NOT network assets

Assessment of efficient costs

- Range of delivery options and future scenarios considered in business plans
- Engagement and 'Buy-in' from stakeholders
- Benchmarking
- Efficient procurement evidence

Incentivising behaviour

- Upfront (strong) incentive rate
- Equalised opex/capex incentives
- Interactions with charging
- Cross-sectoral innovation stimulus, open to third parties
- Tendering of aspects of delivery
- Differential treatment
- Facilitating competition in energy services

Encouraging value for money over the longer term

Set out package of ideas focused on encouraging delivery at value for money over the longer term under an outcomes-led framework:

Re-focused incentives on output delivery, value for money over the long term, working with others, and responding to and anticipating future needs

Innovation stimulus

Competition in delivery and tendering

Options for lengthening elements of the control

Proportionate and differential treatment of networks, reflecting track record for planning/delivery

New business plan requirements would complement these ideas

- The proposed new framework would also encourage networks to consider interactions between the price control and charging
- We set out ideas on options for providing rewards and downsides: explicit rewards, allowed revenue adjustments, and potential constraints on recovery

New business plans

Longer term focus

- Consulting on which aspects of plan should be lengthened
- What should the time horizon be?
- Companies would need to provide evidence of learning over time

Link between outcomes and costs

- Greater onus on benchmarking and efficient procurement

Consideration of multiple options

- Take account of range of delivery options and future scenarios

Evidence of stakeholder engagement

- Effective engagement on options presented in plan
- Evidence of incorporating stakeholder's views

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