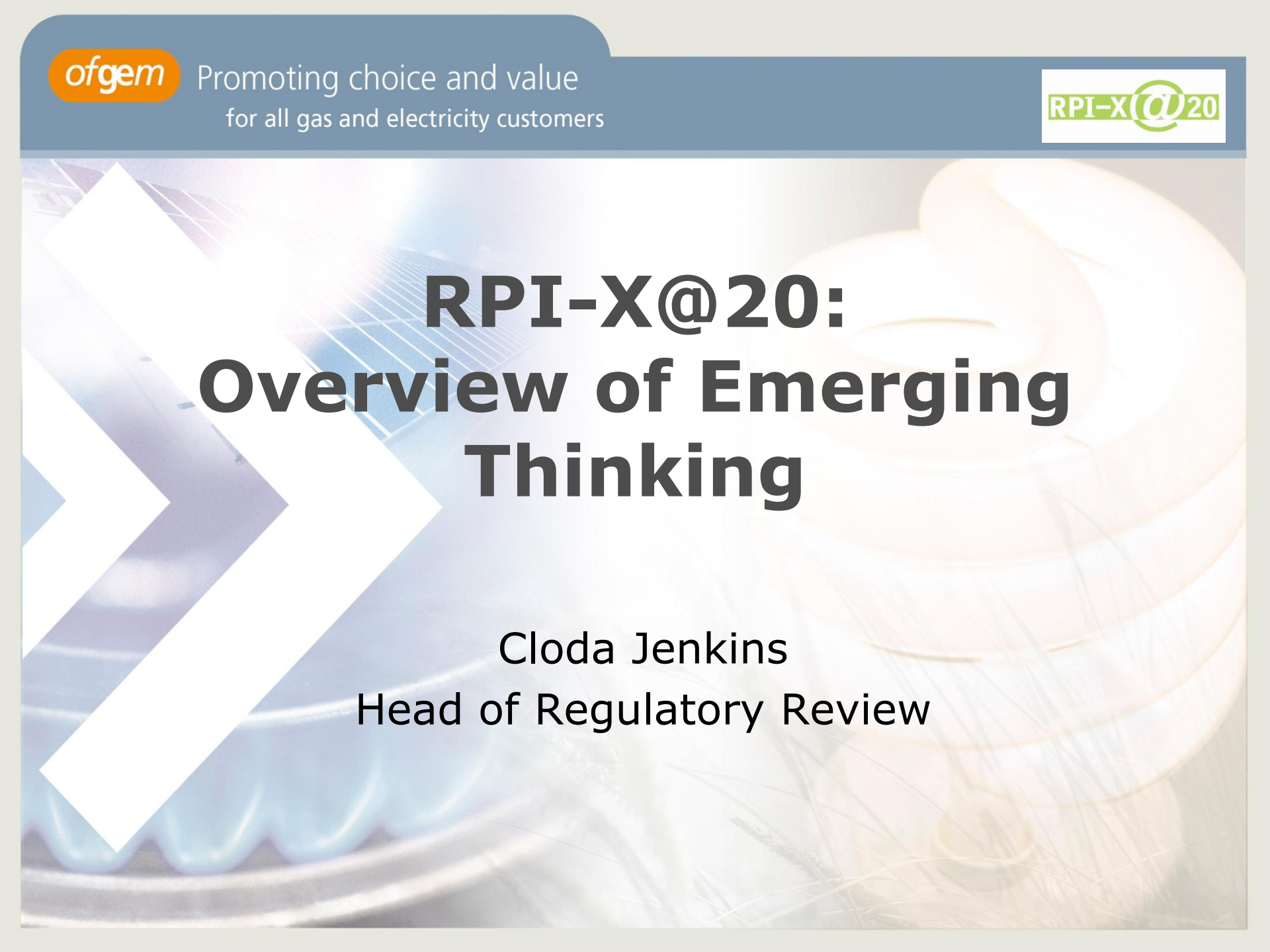


RPI-X@20: Academic workshop on emerging thinking

Introduction from Chairman

Michael Pollitt
Cambridge University

The background of the slide features a large, stylized white arrow pointing to the right, set against a blurred image of a modern building with a glass facade and a large, glowing orange and white circular graphic on the right side.

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

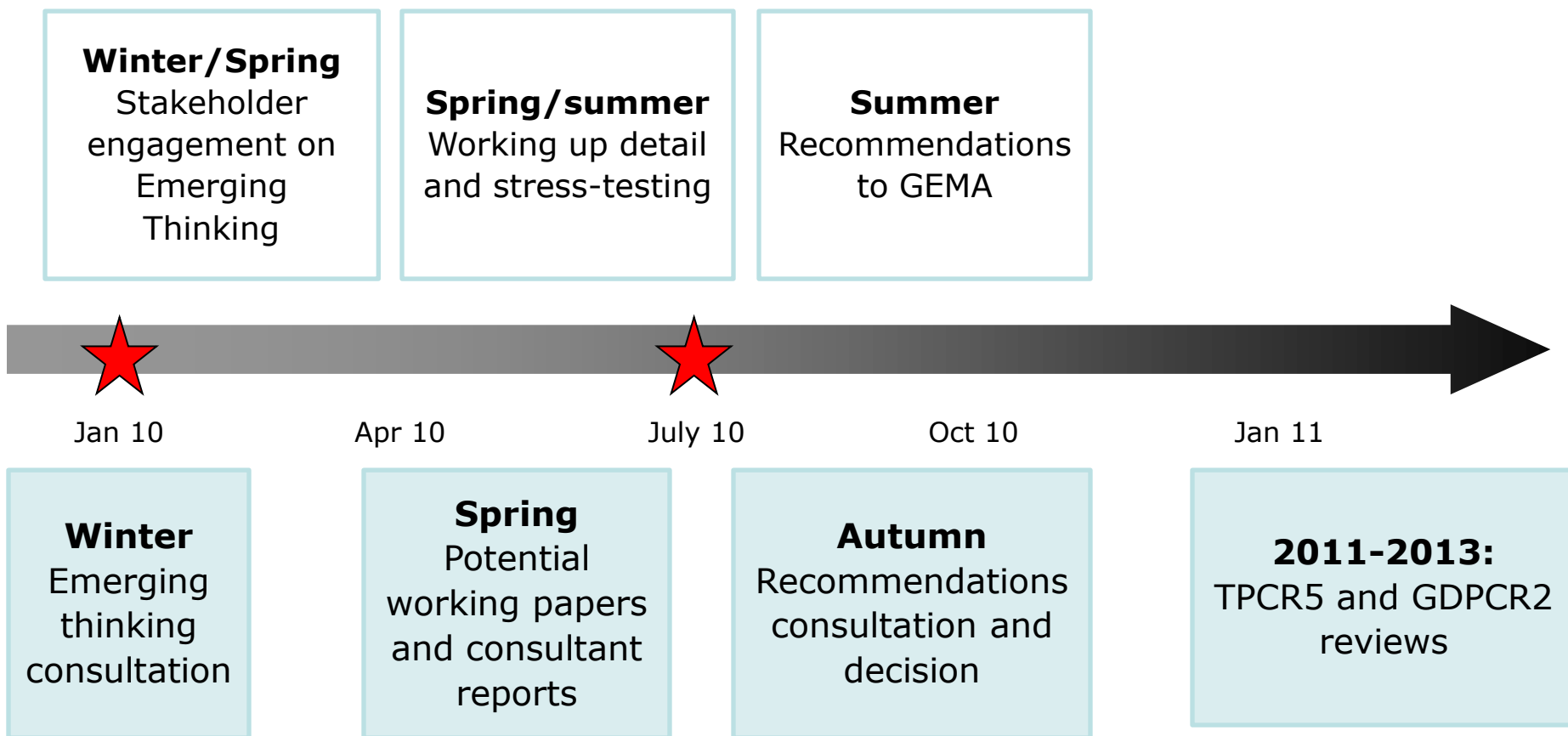
Financeability

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



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

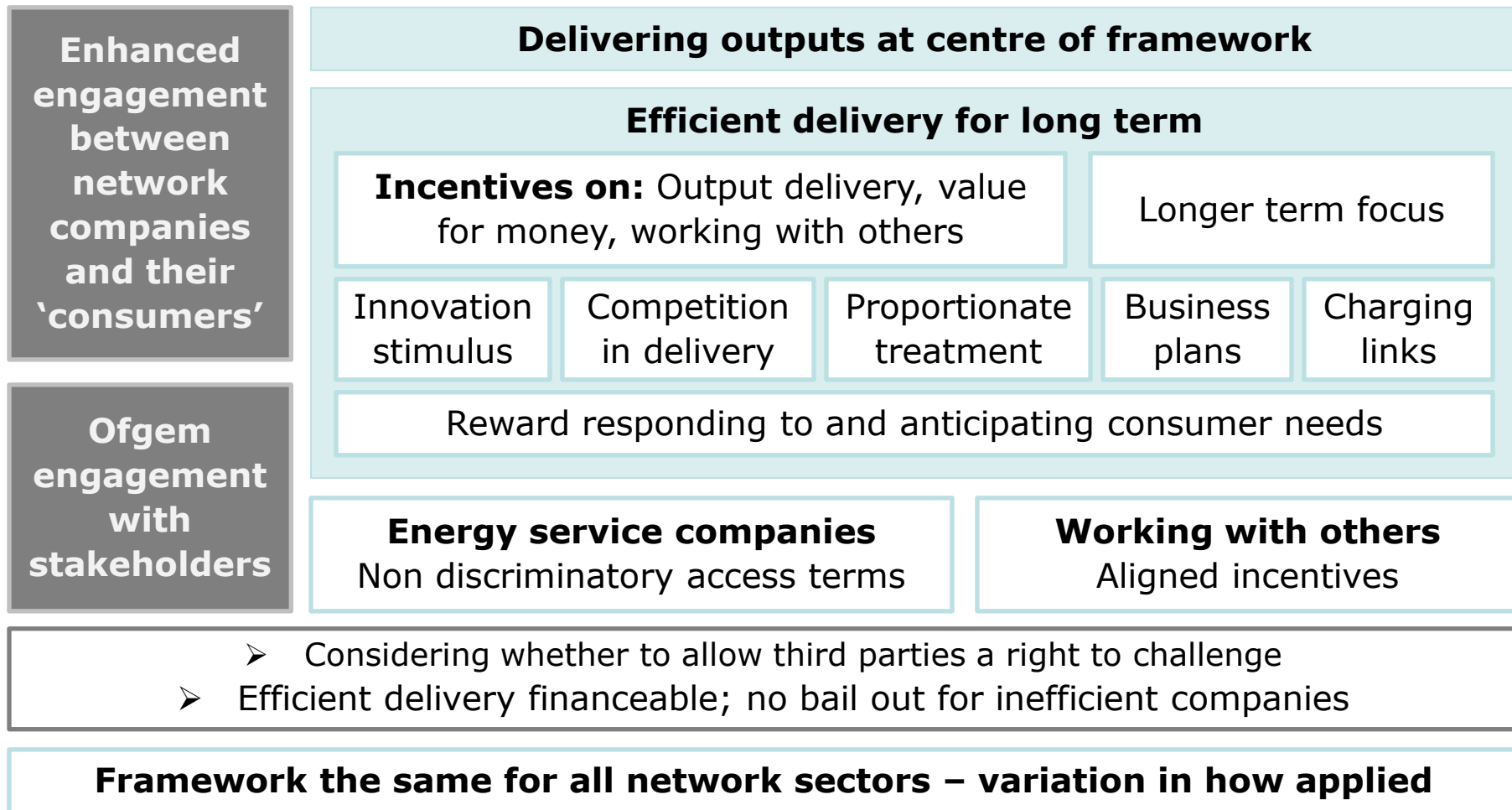
What could change? How price control is set



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



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

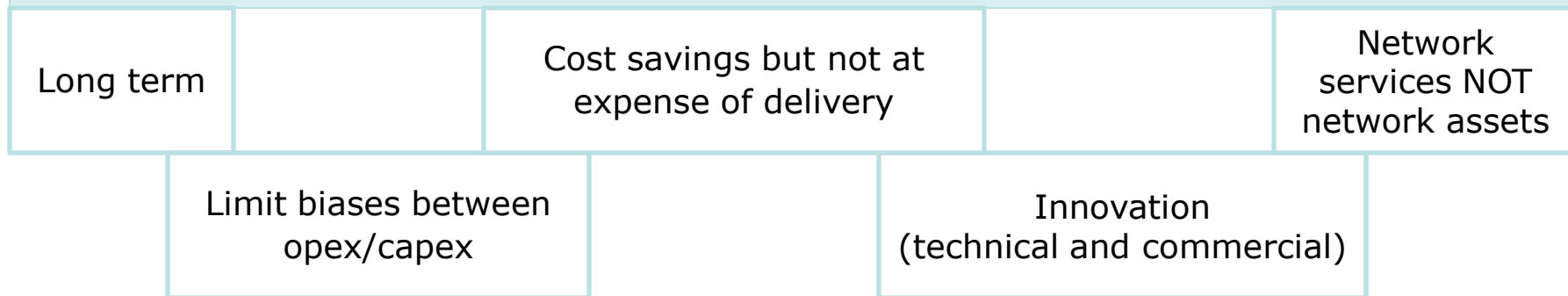
Delivery
performance
impacts on
future reviews

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'



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

The new regulatory framework will encourage:

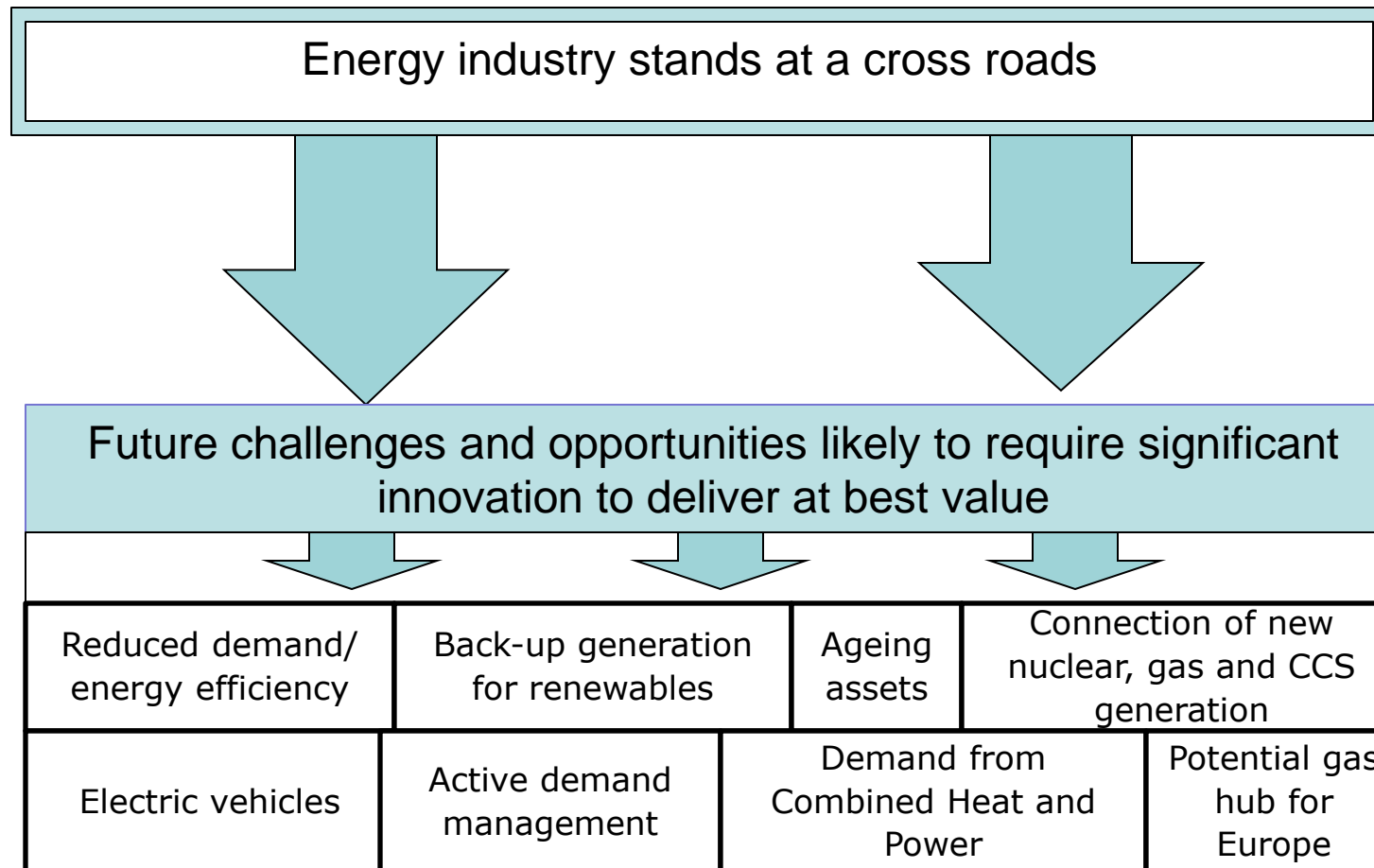
- **Innovation on energy networks**
- **Delivery of a sectoral solution to delivery of a low carbon economy.**

Iain Morgan

Senior Regulatory Economist

Respondent: Goran Strbac,
Imperial College, London

Need for greater innovation



New regulatory framework and innovation

Outputs

Rewards for delivery without specifying how to deliver

Longer price controls

Regulatory certainty over longer time horizon

Effective engagement

Greater access to third party views

Business plans

Different delivery methods presented by network company

Tendering within toolkit

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

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
Design
Joint outputs

Business plan
Demonstrate effective
engagement

Efficiency incentives
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

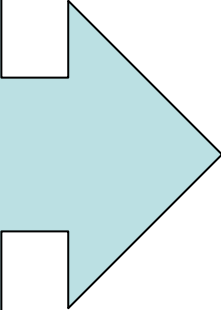
Making information
more accessible

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

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

The background of the slide is a composite image. On the left, there are rows of solar panels under a bright sun. On the right, a hand is shown holding a white document. In the bottom left corner, a blue gas burner is visible. The overall theme is energy and customer service.

ofgem

Promoting choice and value
for all gas and electricity customers