

RPI-X@20

Questions from the Emerging Thinking Document

Chapter 1 – A new regulatory framework for a sustainable energy sector

Question 1: Do you think our desired outcomes for the future regulatory framework are appropriate? Are there any we have missed?

It's clear that the UK faces considerable change if it is to meet carbon reduction targets. We support the tailoring of the regulatory framework to achieve this and we are committed to playing our part in creating a sustainable and low carbon energy sector.

We anticipate significantly greater connection to and use of distribution networks resulting from the electrification of transport and heat as well as intermittent and distributed power generation. We agree that the appropriate outcomes for network companies include safety, customer satisfaction, reliability, new connections, meeting environmental targets and social obligations.

The role of networks is therefore appropriately set out in the paper i.e. to facilitate the transformation whilst maintaining safe and secure networks capable of meeting the needs of our customers and other stakeholders in an efficient, effective and coordinated way.

In addition, we suggest that there will also be outcomes and outputs that are difficult to quantify and are not suited to simplistic analysis, e.g. investment that does not directly contribute to health or load indices but may increase flexibility or reduce risk. While flexibility is difficult to measure, we believe that a greater degree of flexibility will be required in the future as networks evolve and the requirements become more complex. Therefore we believe that while the outcomes framework is correct, the output measures must be understood within the context of the wider business plan, and the industry should work to develop a comparable measure for network risk.

Question 2: Do you agree that we need a fundamental change to the existing 'RPI- X' frameworks to ensure these outcomes are delivered?

Having completed DR5, we have encountered many of the aspects within the new framework, notably

- Placing output measures, and accountability for delivery at the centre of the framework
- Increased focus on stakeholder engagement
- Introduction of an innovation stimulus package

We believe these are positive changes and support their transfer to other energy networks via a common regulatory framework. We do not yet know whether further fundamental changes need to be made to the framework to ensure the desired outcomes are delivered. Some of the additional proposed changes such as increasing competition in delivery, third party right to challenge, “proportionate” treatment etc. have less potential benefit than the changes already included in DPCR5 and may even be detrimental as outlined in our answers to questions relating to those issues.

Question 3: *Do you think the suggested new framework is the best way of delivering these outcomes in the future? Are there any aspects you would change? Have we missed any key aspects?*

One key aspect that is not addressed within the proposed framework is the increased risk associated with transforming our networks to facilitate sustainable and low carbon energy. Significant investment is required to change a network constructed to allow flow from centralized generation to one that can manage the greater flows associated with embedded generation as well as increased electrification, particularly in more rural areas. For networks to be ready to facilitate the changes then a more proactive approach must be taken, rather than reactive investment. The risk results from the high degree of uncertainty around the location and timing of required network investment. If network companies invest too early they risk investing inappropriately or inefficiently, however if they invest too late they could compromise the environmental target deadlines. This review therefore needs to consider how this uncertainty can be minimised and who should bear the risk?

While some risk can be reduced through engagement with stakeholders, there will be cases where the best course of action is a ‘wait and see’ approach, which is why output incentives need to be flexible and recognize that deferring delivery can be an appropriate action.

A key question is then, ‘who should take and fund the residual risk?’ Should networks manage this through increased rate of return, or customers through inclusion of such costs in the regulatory framework?

A related question is ‘who pays for this change’. At a networks level the party imposing the costs suffers the respective proportion in terms of connection. Whilst there are provisions to recover additional costs against second comers, the initial connection costs may provide a barrier to progress i.e. a DG who triggers reinforcement may suffer a significant cost or a customer who triggers reinforcement due to micro generation may suffer a disproportionate connection cost.

There is a risk that the difference in cost between first, second and subsequent parties to connect encourages potential DG customers to wait rather than to act, which will not help in achieving our environmental targets.

We believe that the importance of transforming our networks and the wider social benefits that accrue from a sustainable energy sector warrant greater socialization of these costs. We believe that this is in line with Government policies that use the tax system to socialize the costs of climate change initiatives.

There are some aspects of the proposed framework that we would change, in terms of competition in delivery, proportionate treatment and the third party right to challenge.

Chapter 2 – Outcomes led framework

Question 1: *Do you agree that a new regulatory framework should focus on delivery of desired outcomes?*

We absolutely believe in the use of outcomes as part of the management process for networks, and therefore fully support their use within the regulatory framework. Focussing on outputs also allows network companies flexibility and innovation of approach whilst still delivering the desired

outcomes. The extent of the focus on such outputs however does need careful consideration to avoid incentivising companies to only carry out work which has easily measurable outcomes, when other work could add greater value.

Question 2: *Do you have any comments on the categories of outputs related to these outcomes?*

We do agree with the categories of outputs suggested – reliability, safety, environment, connections and customer satisfaction, associated with value for money. In addition, as our experience develops, it would ultimately be helpful if the measures became consistent across DNOs if they are to be used for comparison, and especially if the ultimate intention is to develop a comparable measure of overall network risk.

Question 3: *Do you have any comments on how these outputs should be incorporated into the new regulatory framework?*

We see outputs as an important component of the regulatory process, but we are keen to see them developed to enhance the clarity of the regulatory contract and its delivery, rather than direct it inappropriately.

Our network management activity is always seeking the most efficient actions in both the short and long term. Whilst much of this activity readily translates to measurable outcomes, many of the decisions taken are much more complex and do not translate well into reliable quantifiable metrics.

We absolutely do not wish to see businesses reacting perversely purely to deliver outputs that inevitably do not reflect the many dimensions of network management. For example, given the current level of uncertainty around the significant changes that are to affect distribution networks and lead times to deliver change, a wait and see approach may be appropriate in some situations. It is important that the imposition of outputs still provides this flexibility and network operators are not driven the deliver investment to achieve short term targets which prove unnecessary in the future.

Outputs are therefore important, and should continue to be developed, but as just part of the overall regulatory framework.

Chapter 3 – Effective engagement and accountability

Question 1: *Do you agree that it is appropriate for network companies and Ofgem to improve their engagement with stakeholders as a way of improving the quality and legitimacy of decision making? Do you have any ideas on how to improve engagement by network companies and Ofgem?*

We agree that stakeholder engagement is essential to understanding and fulfilling stakeholders' needs. Engagement also enables the co-ordination necessary to deliver plans efficiently, for example, engaging with the Environment Agency allows their flooding defense plans to be taken into account when network companies determine their own flood risk management plan.

We see stakeholder engagement as an essential element of the process to transform our networks to enable low carbon generation, greater use of electric vehicles and heat pumps etc. The extent and speed of change is currently uncertain. To minimise the risk both in networks being ready in time and in avoiding stranded investment, greater engagement will be essential to provide as

credible a vision as possible and hence sufficiently robust plans. The extent of engagement will be an important test as to robustness, efficiency and innovation of network plans and investment.

Network companies can sometimes find their stakeholders' needs are mutually exclusive and so while this can inform decision making, network companies will not always be able to satisfy all stakeholders.

We believe the introduction of the stakeholder engagement element in the DPCR5 community satisfaction incentive is a good way to encourage the continuation of the stakeholder engagement work that was carried out for DPCR5 and that similar incentives may be appropriate for other network companies.

Question 2: Do you think we should consider introducing a third-party merits-based right to challenge our final price control proposals?

Given the increased emphasis on stakeholder engagement within the framework, there does not seem to be value in introducing a third-party merits-based right to challenge the final price control proposals.

Third parties are currently given an opportunity to influence price controls via;

- stakeholder engagement with the network companies
- responding to public consultation documents
- meetings with Ofgem

The third party right to challenge would suggest that their views had significant merit and yet had not been given due attention by either Ofgem or the network companies during a price control. This seems an unlikely circumstance, but if it were to occur the more obvious response would be to review the mechanisms for stakeholder engagement, use of consultation responses etc. therefore there would appear to be little benefit from this provision.

There would however be potential problems arising from this right to challenge.

- 1) Delay and expense from frivolous or vexatious challenges
- 2) Wasted effort by network companies during price controls preparing for potential challenges and referrals that may or may not materialise.
- 3) Other potential problems where the views of an individual group conflict with the needs of the majority; or where the needs of future customers are not adequately considered by present customers.

Chapter 4 – Incentivising efficient long term delivery

Question 1: Do you have views on our suggestion that financial commitments could be provided for longer than five years for some elements of the price control? What would be the appropriate length of this partial „longer “ period? To which aspects of the control might it be appropriate to give a longer-term commitment?

There is a potential issue that demonstrating value for money in the timeframe of a price control could limit long term efficiency. This would be seen where the costs fall in one price control and benefits are claimed for customers in subsequent periods. Also, companies could invest in the current price control where benefits are seen in subsequent price controls i.e. Quality of Supply benefits.

We do not believe that the way to counter this is by a complete and extensive extension to the price control as this would significantly increase risks to companies and customers.

Instead, to pick up long term efficiencies, companies' plans should extend to at least 20 years, including outcomes, which are signed onto. The price control to fund this may or may not be extended but what is essential is that trade-offs over time are captured i.e. where costs incurred now and funded by companies deliver future benefits (cost, quality etc), those future benefits also accrue to shareholders. This could be by extending elements of the price control controllable by companies, with non-controllable aspects being subject to drivers or re-openers, or by operating a change control process around a 20 year vision and plan to ensure costs and benefits align.

Question 2: *Do you have views on our suggestions on what business plans might look like in the new regulatory framework?*

As explained for the previous question, we envisage that high level business plans could be extended to at least 20 years based upon a vision which may be informed by government policy. Part of the Price review could examine changes to the plans and drivers.

Question 3: *Do you have comments on our ideas on how efficient costs might be assessed in the new regulatory framework?*

We support the proposed use of a mix of techniques to assess efficient costs and believe that there is a need to include total cost benchmarking within this mix to ensure that a long term view of efficiency is taken. This would effectively mirror the shift to a total cost approach that has taken place via equalised cost incentives in DR5.

The consultation paper suggests that companies would be expected to "provide evidence of their own benchmarking and efficient procurement strategies." (Emerging thinking paper 4.14) For companies to carry out their own benchmarking they will need access to the relevant data. Currently electricity DNOs exchange a limited set of data on a voluntary basis but have not yet considered what data they will be prepared to share for the revised reporting templates. Similarly information about other company's procurement strategies must be exchanged for companies to assess the efficiency of their own strategy. If this requirement is to be satisfied, then there will need to be an element of compulsory data sharing. In any case it is likely that it would be more efficient for Ofgem to compile a shared data set than for each DNO to try to do this individually.

When considering whether procurement strategies are efficient, similar issues will arise to those outlined in our response to questions 4 and 8 in this chapter in that cost may not be the only consideration.

In the supporting paper Ofgem suggests that they expect to see information about costs from competitive tendering. There may be issues of confidentiality around this information and this will need to be handled sensitively.

Question 4: *Do you have comments on our ideas on how efficient long-term delivery might be incentivised in the new regulatory framework?*

We agree with Ofgem's view of a common incentive rate for costs and incentive rates being known in advance, taking account of customers' long term willingness to pay.

We believe that customers will get value for money where companies can be assured that their actions (and costs) are rewarded, even over a protracted time period.

The incentive framework needs to incentivise delivering more work overall with the available skills, to provide a better network for the future, rather than driving down unit costs in one area to increase them in another. Where improved value for money is demonstrated in improved outputs, rather than reduced costs, then companies should also be rewarded in the framework. The additional value could be assessed by analyzing customers' willingness to pay.

Our Alliance arrangement has been designed to deliver more work with the available skills. With a 10 year agreement it encourages investment in programming and multi-skilling to make best use of resources.

Question 5: *Do you have comments on our suggestions of how the new regulatory framework might encourage network companies to anticipate and deliver on the needs of existing and future consumers and network users?*

While stakeholder engagement may help companies anticipate the needs of customers there will still be risk associated with investment to transform networks to enable low carbon technologies.

Surety of delivery may compromise efficiency and could result in stranded costs whereas certainty of efficiency may compromise delivery.

We do not want networks to be a barrier to delivering longer term environmental targets, particularly given our obligations to facilitate competition in generation, and hence we believe it is more important to ensure delivery. However, it is not clear in the framework who should bear the risk of compromised efficiency or stranded costs associated with that approach.

This may be networks through a potentially higher cost of capital or incentive rate, or customers through ex-ante authorisation of investment being included in the RAV.

Question 6: *Do you have views on our ideas on how the interactions between charging and price review incentives might be taken into account at price reviews?*

Given the need to efficiently build and operate the networks, which would include tariffs and the opportunity of changing behaviours to align with capacity, it seems perfectly sensible. Tariffs should have a clear link to efficient network usage and hence construction.

Question 7: *Do you have comments on our suggestion to treat companies differently at the price control, both in terms of process and incentives, reflecting planning and delivery performance?*

Companies are different to each other in the distinctive features of their operating region, their ownership structures, historic factors, and their strengths and weaknesses. Emerging technologies are likely to increase these differences e.g. different levels of embedded wind generation, or uptake of distributed generation, electric vehicles etc. The key issue is determining which differences result in valid differential treatment and where this would be discriminatory.

To a certain extent there has always been differential treatment of companies in terms of the degree of challenge they are exposed to. Those companies that put forward robust and well consulted on plans that are easy to understand will receive fewer questions from Ofgem than those whose plans are sketchy, poorly justified and unclear. Similarly those companies who appear to be high cost outliers are more likely in need to provide additional information. While this approach is reasonable, it is questionable whether this should be formalised and extended to result in very different processes or incentives.

Firstly it seems unnecessary to provide an additional reward/incentive as those companies with a good reputation would already enjoy significant benefits i.e. the rewards from the various performance incentives and having greater influence with Ofgem.

Discretionary rewards are currently used to reward star performers. There seems little value in adding a layer of complexity to determine the right of a company to participate in incentives when the incentive schemes should naturally operate to reward or penalise companies according to their performance. As such this could be an additional distraction to companies that already face significant challenges in the years ahead.

Such an approach is likely to result in accusations of favouritism and discrimination and would require very clear criteria and justification. Even so it is likely that Ofgem would need to spend a great deal of time in their evaluation and justification, which seems to negate the benefits of such an approach.

We are facing a period of change and uncertainty where it is likely that the adoption of new technologies will vary between regions. From a customer perspective, we believe that customers would not feel their interests were given the same priority if their DNO was subjected to differential treatment, such as a very different process for scrutiny.

As well as the conceptual difficulties there would be practical issues as well.

There are various issues in determining which companies have a good reputation.

- different benchmarking measures will rank companies differently
- delivery performance (rather than cost efficiency) relies on relatively new measures and needs to reflect different levels of delivery risk
- In reality, the difference between companies will be narrow which may make judgements seem arbitrary and discriminatory, especially into the five categories suggested in table 2 on page 24 of the supporting paper.
- performance changes over time and so reputational advantages must be time limited

While Ofgem acknowledges the need to evaluate performance and ensure that any undeserved advantage is subsequently corrected, this seems to add more in terms of additional complexity, when this differential treatment is intended to reduce the regulatory burden.

To allow for comparative analysis data must be provided by all companies on a consistent basis and so those companies with good reputation would still need to provide the same level of information which should be subjected to the same degree of scrutiny. Therefore while there may be an intention to regulate some companies with a lighter touch, this may not be possible in practice.

The recent problems at Stafford Hospital show that reputation can be misleading as while patient care was clearly sub-standard the hospital received favourable reviews from external bodies. Also that the desire for Trust status, which would entitle them to reduced external scrutiny, was a motivational factor that worked against the delivery of high quality services.

Question 8: *Do you have views on our suggestion to open up some aspects of delivery to competition?*

We agree with Ofgem that it necessary to ensure that companies deliver efficiently. However, it is for the companies themselves to determine the most efficient balance of insourcing and outsourcing, and outsourcing strategies to deliver the best value for money. For DNOs, benchmarking will uncover inefficiencies resulting from poor choices around the use of contractors, therefore Ofgem do not need to challenge this aspect separately. However, we can see that this may not be the case for Transmission.

We don't believe that a company's use of contractors can be assessed simplistically, nor that mandatory outsourcing would deliver benefits.

When assessing whether work is most efficiently carried out by in-house staff or contractors, cost is not the only factor. The decision may be affected by;

- safety considerations
- the need to maintain in-house skills. These are likely to be increasingly important.
- the need to ensure a minimum in-house staffing level (e.g. to manage an unknown volume of unplanned work and resilience during network emergencies.)

Outsourcing does not automatically result in higher efficiency. Evidence can be drawn from the benchmarking analysis for DPCR5. While economic theory would predict that companies that employed more outsourcing would be more efficient, this was not necessarily the case. Typically there is some inefficiency during the "bedding in" period for a new contract when there may be many issues to resolve. Similarly at the end of a contract, a contractor that knows their contract has not been renewed is likely to see a reduction in motivation and efficiency. Placing many short term contracts can create an unstable workplace which is bad for staff wellbeing. Placing many contracts for smaller volumes of work may not be beneficial overall if savings from lower unit costs are outweighed by inefficiency due to greater travel time, multiple teams visiting site and a lack of accountability.

Traditionally, competitive tendering was seen as the way to get value, and to some extent this can still play a part, but in these days of resource constraint the best way to get value is to award long frameworks protecting skills and to incentivise cost reduction and value improvement. Our Alliance has been developed to provide those incentives within a longer term agreement ensuring greater commitment from both parties.

When considering whether tendering should be mandated or carried out by Ofgem there are additional concerns.

- Lead times are typically 3 years, so if individual projects are to be tendered outside of the company's control, this would need to be 4 years in advance, and would lead to further uncertainty under the frameworks with regards volumes of work and therefore scaling up production.
- The impact of EU Procurement Legislation imposes certain requirements in terms of both timescales and process.
- We are increasingly entering into longer term contractual commitments with suppliers. Any decision to tender activity would have to be mindful of contractual obligations which a network operator had already entered into.
- PFI contracts highlight the potential problems with mandatory tendering. These contracts have not generally been considered efficient.
- In the event of a compulsory tender exercise not having the desired result or it having a negative impact on network performance and/or customers, who would carry the risk and any related consequences?

Ofgem believed outsourcing may have other benefits than simply cost, such as allowing work to be completed sooner or with a more favorable financing structure. Problems around the speed of work would presumably be reflected in the companies' stakeholder engagement work and customer satisfaction ratings and as such would be picked up in Ofgem's analysis of the business plan. Additionally the proposed framework would consider how well a company has anticipated the future needs, so there seem plenty of ways to address such an issue without resorting to compulsory tendering.

Question 9: *Do you have comments on the design of a cross-sectoral time-limited innovation stimulus that is open to a range of parties?*

There is ultimately a clear need to develop a mechanism that delivers energy in the most efficient way to home and business applications, and this is most likely to be optimised by introducing cross sector solutions.

It seems unlikely that the level of innovation required will reduce at the end of the Low Carbon Network Fund period, but equally efficient future energy solutions will not be delivered by innovation alone. The 2020 renewables targets as well as the 2050 climate change targets are very challenging, and a period of replication is required to make sure that UK has the functionality needed in all areas, albeit continuously supported by further ongoing innovation.

While the innovation stimulus package is a useful addition to the current regulatory framework, it may be better in the long term to shape the regulatory framework so that it naturally encourages innovation. At present the 5 year time horizon acts to reduce incurring costs in the current price control that results in benefits in a later price control.

Question 10: *Do you have comments on our straw man on how we would embed our financeability duty into the new regulatory framework?*

Ofgem has a key obligation to ensure a business is able to finance its activities. Ofgem must continue to fulfill this obligation. When considering financeability, considerations to protecting debt holders must be matched with adequately understanding and attracting equity holders. We outline our views on financeability in more depth in the attached document which considers the issues raised by Ofgem’s document “Emerging Thinking – Embedding financeability in a new regulatory framework”

Chapter 5 – Cross sectoral solutions for a sustainable energy sector

Question 1: Do you agree that a new regulatory framework can deliver our desired outcomes within the existing industry structure?

Yes, we agree that there does not seem to be any need to change the industry structure.

Question 2: *Do you agree that it is appropriate to encourage network companies to work with others to identify cross-sectoral solutions to the challenges the sector faces?*

Partnering with other companies brings expertise from different areas together which can stimulate innovation. DNOs are very aware of their obligation to not distort competition and provide access on reasonable terms. More guidance will be required as to how partnerships can be fostered with one company in a different sector without this being seen as discriminatory. For example demand side management at a particular network location would naturally involve location specific customers and generators. It is not yet clear whether business separation requirements are likely to be a barrier to such cross-sectoral partnerships.

As with the rest of the framework, innovative or highly performing companies should be rewarded.

Question 3: *Do you agree that the regulatory framework should ensure energy network companies facilitate effective competition in energy services?*

While we expect energy service companies to play a stronger role in the future, there is currently uncertainty around what energy services will do, how they will operate, how many companies there will be etc. which makes answering this question highly speculative. Without understanding what the actual requirements would be to support effective competition, it is difficult to make a judgement at this stage. We would not expect network companies to be disadvantaged in fulfilling the required changes.

However, we strongly believe there will be a role for DNOs to facilitate energy services and facilitate the transition to a low carbon economy, and we would not expect energy network companies to operate in a discriminatory manner.