



**Consumer
Focus**
Campaigning for a fair deal

Consumer Focus response to Ofgem's RPI-X@20 Emerging Thinking consultation

April 2010

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About us

Consumer Focus is the statutory consumer champion for England, Wales, Scotland and (for postal consumers) Northern Ireland. We operate across the whole of the economy, persuading businesses, public services and policy makers to put consumers at the heart of what they do.

Consumer Focus tackles the issues that matter to consumers, and aims to give people a stronger voice.

We don't just draw attention to problems – we work with consumers and with a range of organisations to champion creative solutions that make a difference to consumers' lives.

Introduction

Consumer Focus welcomes the opportunity to respond to this important consultation on the future regulation of networks. At this stage we have focused on the main proposals document and the consultation on the third party rights of appeal.

In summary Consumer Focus believes that:

- Ofgem's proposed package represents a good balance between building on current strengths and developing new initiatives
- the proposed shift to outcome-led approaches has merit and should benefit consumers now and in the future, but more detail is required on the definitions and how they would be applied
- we like the idea of a balanced score-card with a mix of measures, but there should be a core of common metrics applying to all companies for each review and a mix of sectoral and individual targets
- increased consumer engagement is very necessary but needs to be properly focused if it is to deliver real benefits
- better engagement by network operators can be achieved by adopting a set timetable for each generic price review. This should be published in advance with a fixed period set at the commencement of the process to allow the regulated companies to consult with their stakeholders
- there should be a common template for delivering each company's business plan and its price control proposals to the regulator. The draft plan should form the basis of the consultation with stakeholders and highlight its price/service proposals; the final plan submitted to the regulator should indicate how these proposals have been formulated to take on board stakeholder (including consumer) feed-back and preferences
- consumer engagement should be the norm and those companies that do it well should not be specifically rewarded, though an output measure could be developed reflecting company performance. Those that do not consult appropriately or properly should be penalised
- we are nervous about and do not support extending price control terms longer than the current five years
- we support the intention of rationalising incentives and mechanisms, but it is unclear from the current documentation how Ofgem intends to pursue this goal
- similarly, while the concepts of increasing transparency and simplicity have merit, it is not obvious that the proposals as they stand deliver them
- a third party merits-based right of challenge may, in theory, appear to foster stakeholder engagement and would also be consistent with better regulation principles. However, at this time, we can only provide limited support for the establishment of such a right as we have serious concerns about the proposed approach and believe further work and discussion is required before we could give full support to this proposal

Our response

Consumer Focus welcomes the opportunity to respond to this important consultation on the future regulation of networks. At this stage we have focused on the main proposals document and the consultation on the third party rights of appeal.

A sensible package

We consider that RPI-X has been a largely effective and flexible form of regulation in the past, and we support the proposal to adapt and develop the current framework, rather than to replace it with another type of framework. While regulation must focus on encouraging companies to become more efficient, it should also encourage them to deliver outputs which meet the Government's environmental targets. To deliver these objectives effectively we need a framework which is enduring but capable of adapting to changing circumstances. This is particularly the case given the major programme of investment that is needed to ensure affordable security of supply and simultaneously deliver emissions reductions targets. At the same time it is very important that any changes should not unnecessarily undermine the degree of certainty and predictability that the current framework provides.

It can be argued that RPI-X regimes tends to over-reward the maintenance of existing assets to the detriment of investments of a more speculative nature. Given the necessity to transfer to a lower carbon economy, there will be a need to find ways to change this conservative mentality. The Low Carbon Networks Fund is a good example, but may not be sufficient in itself. Ofgem may wish to look at setting price controls that allow a differentiated return on investment for different kinds of network activity – reducing windfall gains from the maintenance of existing assets that are essentially risk-free, while increasing incentives on networks to be creative in developing their networks to recognise the changing public policy demands that networks need to deliver.

We are supportive of the propositions that the regulatory framework should encourage energy network companies to a) play a full role in facilitating delivery of a sustainable energy sector and b) deliver value for money network services over the long term for existing and future consumers. But we think that Ofgem needs to consider how to balance targets and goals at a lower level of detail, in particular to recognise the inter-dependencies between goals related to different sets of objectives, most obviously between environmental objectives and social obligations.

While many aspects of the proposals for change in the emerging thinking documentation appear fine in principle, there is sometimes very little detail to test this judgment against. We think it will be necessary to set out how some aspects of the package, such as greater consumer engagement, are going to work in practice and why they are likely to be effective.

We have set out some views in each of the main proposal areas below which we hope should help inform the more detailed recommendations that Ofgem intends to develop on how, when and where each element of the framework will be applied.

Outcomes-led price controls

We support Ofgem's proposal that a new regulatory framework should focus on delivery of desired outcomes, rather than on how a network company should conduct its business processes. Consumers as well as the companies should understand what network companies are expected to deliver in return for the allowed revenues set in price controls, particularly in an environment where they are being asked to bear the increasing costs of meeting sustainability objectives.

The development of clearly defined outputs is also crucial in relation to facilitating greater consumer engagement – which is a worthwhile objective in itself – assuming that at least some of these outputs are defined relative to consumer preferences. By focusing on what is delivered, rather than how, the framework should encourage network companies to identify the best means of delivery, which in turn should help encourage innovation. We think a focus on well-defined outputs should help the network companies to adjust mindsets to move from a world in which the driving focus is on increasing efficiency, to one where there are more complex and uncertain drivers for investment.

We note that Ofgem intends for its summer 2010 recommendations to set out the principles to consider when establishing the set of output categories and to develop initial ideas on potential outputs in each of the sectors. In general the lack of any proposed indicators at this stage makes it hard to assess how the overall design may look in practice. However we welcome the initial ideas on principles and types of output for the environmental category in the supporting documentation, although these clearly need significant further development. Following are the considerations that we believe are important in the further development of outputs.

We note there is a lack of discussion of the inter-dependencies between the different categories of outputs, for example, between environmental targets and companies' social obligations. These issues will need to be addressed in order to establish a set of outputs that is coherent across the piece, and we think that a combination of techniques including cost-benefit analysis and risk analysis could help in achieving this.

Outputs need to be defined at a level of detail that is clearly understood by all parties involved in any enhanced engagement process. We support Ofgem's view that the outputs will need to encompass both a wide range of quantitative, both financial and non-financial, **and** qualitative measures. We believe the categories of outputs proposed appear to capture the key elements within the proposed balanced scorecard approach, namely: reliability of network services and the wider system; safety; environmental targets; conditions for connecting to network services; customer satisfaction and network-related social obligations.

We also agree that there will need to be a mix of sectoral **and** individual targets, and we also support the need for 'leading measures' to provide information on risk to future delivery as well as 'lagging measures' to provide information on delivery performance. An important aspect of the proposed output-based framework is that it will create a much greater focus on performance and evaluation after the period(s) to which the outputs relate. But we also need to understand much better how the process of evaluation, aggregation and rationalisation of incentives will be carried out before any final judgments can be made on the proposed package.

We consider that Ofgem's Consumer First programme has proved very valuable in identifying consumer views and providing insight to the regulator. We support the continued use and development of this approach going forward. But in addition to this, the network companies individually will need to show that they have consulted meaningfully with their consumers and other stakeholders on the outputs that they are proposing to set and their level perhaps within a framework set by Ofgem.

Setting the level of outputs that the network companies will be required to meet is an important judgment.

We strongly agree that network companies do need to be held to account for their performance and see revenue at risk if they do not deliver and they cannot demonstrate that this is in the best interest of existing and future consumers. In this case penalties for non-delivery should be applied. But we are not convinced that as a matter of course the companies should be rewarded for delivering the determined outputs – in general these outputs should specify what is required in return for the allowed revenue. In this respect we think that Ofgem should consider the scope of the objectives that should be set out within the licences and then are subsequently reflected in output measures. In this context we believe the objectives should be specifically modified to include a new duty to take into account demand-side options.

There is a clearly a balance to be struck between having enough required outputs at a sufficient level of detail and creating a complex, over-engineered framework. We have previously expressed concern that the current regulatory framework is overly complex and too disparate and needs simplifying, and we think that without some restraint applied there is a danger that the output framework could become very extensive and unfocused. We note that one of the issues Ofgem will consider is how it might consider the outputs holistically, potentially with a smaller set of weighted overall measures. We think that using total factor productivity or comparable measures of efficiency in the wider economy might provide a possible means of simplifying the outputs or establishing an appropriate hierarchy among them.

Protecting the vulnerable

The previous RPI-X@20 consultation noted the importance of social objectives to delivering sustainable outcomes. It also commented on views that have been expressed during preparatory work on the review about whether ‘networks could and should play more of a role in meeting social policy objectives, including metering, fuel poverty targets and potentially wider goals (eg regional regeneration)’¹.

We can find no obvious discussion of these issues in the consultation and the supporting documentation. The framework in Appendix 5 addresses the network companies’ roles in meeting social obligations. But these are limited to such things as maintaining priority registers and complying with guaranteed standards of performance rather than seeking to find innovative ways to address social issues. This is a serious omission as we and other stakeholders believe that there should be a debate regarding the efficacy of using the monopoly part of the energy market to channel social objectives, thus avoiding any hindering of competition. Such a debate could and should be sparked off by the regulator.

There also does not appear to be mention of the need to address the distributional effects of the proposals.

These omissions need to be addressed urgently. It would be useful to have an opportunity to comment on this detail prior to the release of final proposals.

Innovative and efficient delivery for the long term

We support the proposal that companies should provide better information in their plans on outputs and which demonstrate a clear link between output delivery and total costs. It is very important that the outputs framework is used to maximum extent to provide value for money for consumers. This means that outputs need to be defined to an appropriate level of detail and carefully monitored and that, if forecast costs prove wrong or are overstated, unnecessary revenue allowances are clawed back. It also means that there needs to be core common indicators that enable performance across companies to be measured over time.

¹<http://bit.ly/cF6aek>

We are nervous about, and do not support as a general approach, extending price control terms longer than the current five years. We understand the risk that the current regulatory arrangements may mean that companies focus their efforts on the five-year price control window at the expense of actions that could reduce or restrain costs over the longer term. But given the extent of the uncertainty over the nature and pace of the changes needed to address the carbon challenge, we think a longer price control would create unacceptable risks of windfall gains for the companies and/or the development of inappropriate technologies. However we support the idea that the network companies should develop longer-term business plans in order to help create a wider perspective within which the five year price controls can sit. In this context network operators could also take a longer-term view of efficiencies.

If the duration of price controls was to be lengthened, it is very important that there are claw-back mechanisms in place to deal with changes that work to their favour but which are outside of management control and to ensure that the network companies are not in a position to make excessive returns. More generally Ofgem should have much greater regard to achieved returns by the regulated businesses and tie results to performance.

We also think that the options being considered by Ofgem to have a mid-term review of outputs or allowed revenue could lead to a substantial increase in complexity in the regime, with greatly increased requirements for monitoring.

We support Ofgem's view that innovation should enable network companies to facilitate the delivery of the 2020 and 2050 low carbon targets and deliver value-for-money for existing and future consumers. Ofgem has placed great store in the current distribution price control on the Low Carbon Network Fund (LCNF), and we are supportive of the idea of introducing a separate innovation stimulus into the new regulatory regime. We also agree with Ofgem's view that it is crucial that the benefits from innovative projects are appropriately shared with consumers, given that they would have largely funded these.

We also welcome the proposal to keep the need for this LCNF mechanism under review given the novelty of the arrangement and the fact its application will be effectively untested over the timescales over which Ofgem will be reaching decisions following the RPI-X@20 review. It is clear that there is significant further work needed before the concept of the smart grid and its delivery is worked through.

In this context we note the recent conclusions of the Electricity Networks Strategy Group² in its road-map calling for much greater co-ordination between Government, industry and consumer bodies in the development of smart grids and the associated incentives.

We note with interest that Ofgem makes reference to the need for networks to improve services and access for energy service companies (ESCOs). We support this approach as we believe it would encourage more community energy efficiency and decentralised heat generation and help in the move towards the move toward a low carbon energy supply. However, Ofgem is completely silent on the detail of this proposal and it is evident that much more detail is required in order to properly assess any new initiative in this area. It would be useful to have an opportunity to comment on this detail prior to the release of final proposals.

Enhanced engagement

We welcome Ofgem's proposals to encourage greater engagement of consumers and their representatives in the regulatory and rate-setting processes. We agree that there are benefits from a properly targeted approach in terms of helping to define what needs to be delivered and how to incorporate customer priorities. If this is done successfully it could greatly increase legitimacy of the outcomes.

² <http://bit.ly/a0mREO> (pdf 686 KB)

Our concern is that enhanced engagement needs to be effectively channelled. Although 'multi-layering' (as described in the documentation) as a concept is useful to describe the increased input from a range of parties, the approach needs to ensure that input and views are captured effectively at the point at which they would be of greatest value.

We think the key here is to provide stakeholders with the opportunity of full and proper discussion of the companies' plans before they are signed-off. This might be achieved through:

- Ofgem establishing with the companies, and backed up with guidance, the coverage of a draft business plan that would set out each company's proposed prices and services going forward and the strategies proposed to deliver them
- an obligation on the companies to consult with consumer representatives in drawing up their plans
- the draft giving price/service proposals for five years but within a development framework that stretched ten years (or longer)
- stakeholders need assurance from the process implemented by Ofgem that the business plans are accurate
- a supporting, unambiguous common timetable for development and delivery of the plan
- identification of the key generic measures in the guidance against which the regulator proposes to evaluate performance (that is, the mandatory elements of the outputs against which should form the back-bone of the proposed scorecard)
- clear narrative within the finalised plan of the steps each company has taken to take on-board stakeholder feed-back and how the plan might deliver customer preferences, and
- the plan then representing the company's proposals for the key elements of the price control

We support the establishment of a price control review forum which would allow interested parties to participate at specific stages in the development of the final regulatory settlement. However, we think it is important that the forum complements and does not replace local dialogue, especially at the front end of the process. This forum should only be convened at critical 'assessment' points in the process once it has picked up momentum, and it should be backed up by focused briefings and clear objectives.

However we do not support the proposal that network companies which demonstrate they engage effectively with the consumers of their network service should be specifically rewarded. This is something that they should be already engaging in. That said, as we have already noted, we agree it is appropriate to consider how views on a network's engagement might be incorporated into some form of 'customer satisfaction' output measure.

In terms of implementation, we acknowledge that there will be learning and development on some aspects of consumer engagement, and the effectiveness of the process will also evolve. There is a need to be realistic about the practicalities of consumer engagement and what was achieved during the recent distribution price control review. But a key enhancement is that the process to be followed for each price review should be clearly defined and timetabled in advance as we have outlined.

We welcome the supporting paper on stakeholder engagement, although this is clearly a starting point, and more detail is required on how this will work in practice, which is recognised in the paper itself.

Third party right of challenge

Ofgem has raised the question of whether a ‘merits-based’ third party right of challenge to proposed price control licence modifications would complement enhanced engagement, and potentially contribute to the quality and legitimacy of its decision-making and that of the network companies. Any challenges would be considered by the Competition Commission.

We are sympathetic to the reasons why this proposal has been raised but can only offer limited support for it at this time. We have serious concerns about the proposed approach and believe further discussion and work is required to address these concerns, in order to make the proposal workable in practice. We recognise the third party right to challenge mechanism offers a form of remedy different to others currently available – such as judicial review or a super complaint – however we are concerned that it would be difficult to make the proposal work in practice.

If this position seems perverse given our statutory remit, it is because while the principle of increasing the transparency and accountability of the price control setting process is clearly a good one, the practicalities of applying the appeal route Ofgem envisages appear very difficult to address at this time. We consider that an unworkable appeal mechanism is likely to be worse than no appeal mechanism at all.

Our concerns on the appeal mechanism can be broken down in to three key areas:

- Ofgem’s remit
- conflicts of interest and the credibility of process
- resourcing and information imbalances

Ofgem’s remit

We believe that granting a right of appeal to another body could be construed as an abrogation of Ofgem’s existing statutory duty. The process of appeal should not detract from Ofgem’s key duty to act on behalf of the consumer and should be considered an enhancement to existing rights rather than a substitution.

Conflicts of interest and the credibility of the process

Ofgem states that one model under consideration is that they act as the gate-keeper of any appeal before any referral by them is made to the Competition Commission.

In effect, this creates a two-stage appeal process:

- a need to successfully win a merits based appeal to Ofgem, in order to gain the right to lodge an appeal to the Competition Commission; followed by
- a merits based appeal to the Competition Commission.

Importantly, notwithstanding its statutory duties, we do not believe that Ofgem could credibly act as the gatekeeper of this process. By its nature, the settlement disputed would be one that it was involved in reaching – so in effect we would be asking a decision making body to refer themselves to a third party for having reached an incorrect decision. This is a clear conflict of interest, and in practical terms we believe that it would be unlikely that Ofgem would make such a referral, as this would be a tacit acknowledgment that an expensive and time-consuming price control process was a failure.

In other similar areas where Ofgem is both decision maker and gate keeper – most notably as the only statutory body who could refer the energy market to the Competition Commission for a market review – it has shown no willingness to expose itself to external scrutiny. We see no reason to believe this would change in relation to a price control settlement.

We have strong concerns about the credibility of the right to challenge process. It is possible the right to challenge may increase pressure to ensure networks 'do the right thing' by consumers. However, we are concerned that this implied protection for consumers provides a false consumer safeguard, as realistically the threat will never actually be acted on for the resourcing reasons already outlined.

The ideal outcome is for Ofgem to do a robust job in the first place and we believe the proposals in the emerging thinking document should increase the probability of such an outcome.

Resourcing and information imbalances

We understand that one of the criteria that Ofgem is considering, to determine if an appeal can go ahead, is if the party involved has 'effectively engaged' during the price control review. We believe that, if this is the case, small organisations such as Consumer Focus would need a great deal more resourcing to meet this expectation. Additional resourcing on top of this would then also be required to undertake the appeal itself.

To put the resourcing issues in context, we understand that at the project's peak Ofgem had several dozen full time equivalent (FTE) staff working on Distribution Price Control Review 5 (DPCR5). We have about 0.5 FTE staff working on all networks' price controls. Reallocating resources could add to this, but it is worthwhile to note that our total head count for all energy issues – electricity and gas, transmission and distribution, network and market, social and environmental policy – collectively amounts to a fraction of the headcount Ofgem has to deploy on a single price control.

Further only Ofgem has access to important information that would be necessary to undertaking an appeal, such as the networks financial data. Accessing this information could become a resourcing issue.

There is some uncertainty about who will pay for the cost of an appeal. Ofgem state that costs could be passed back to the party who raises the appeal. In this event we estimate these costs could range from about £400,000 upwards, which we simply cannot afford.

As with most public bodies we have a relatively limited budget which is currently under severe pressure, and we are highly unlikely to find the additional resources required to undertake an appeal.

There may be ways in which the resourcing issue could be addressed for example, via sharing of resources with other organisations and /or a less resource intensive definition of effective engagement.

Given the importance of price controls and regulation of networks to ensure fair outcomes for consumers we would be happy to discuss our concerns about third party right to challenge further with Ofgem. We hope that if this proposal proceeds our concerns can be resolved satisfactorily. However, given the impetus for this right to challenge comes from Ofgem we believe that the onus rests with Ofgem to ensure that the proposal is workable in practice and is adequately resourced.

Undue complexity

A recurring theme of our previous RPI-X@20 review and DPCR5 responses has been concern over the undue complexity already embedded in the typical price review process. One criticism of Ofgem's approach in the current documentation is that it has not considered in any detail how to address this issue. Indeed, although the document is light on day-to-day operation of the new style of process, we can see much to suggest the processes will become more complex than at present, with a proliferation in guidance and bureaucracy.

We support the proposal to improve the effectiveness and accessibility of information. In introducing a framework which focuses on outputs and includes enhanced stakeholder engagement, there will be a requirement for more accessible information on company plans and performance.

We also think Ofgem should do more to strive for greater simplicity in the kind of language it uses in all relevant documents, including technical ones, as non industry stakeholders can find it difficult to engage with the large quantities of material that a price control review can generate. In this respect water regulator Ofwat's introduction of *Project Explain*³, which includes initiatives to simplify stakeholder communications, would seem to provide an example of what can be achieved.

We also share the concerns relating to the number and variety of different incentive schemes, which create a major part of the complexity in the price controls. While we welcome Ofgem's intention to seek to ensure that new mechanisms are 'streamlined', it is not clear to us what this might in practice entail. We do however welcome the proposal to explore how incentives may be aggregated and consolidated, and how this would fit with the intention to set a greater focus on a small number of key outputs. Regulatory effort should obviously be targeted where it will provide greatest value for consumers.

We support Ofgem's view that any changes should not undermine the certainty and predictability of the current framework. This is particularly the case given the major programme of investment that is needed. To help foster predictability, there needs to be clear explanations of decisions, a process which is repeatable in overall terms and no unexpected surprises that will derail legitimate expectations.

³ <http://bit.ly/9y9jKt> (pdf 1.63 MB)

Consumer Focus response to Ofgem's RPI-X@20 Emerging Thinking consultation

For further information on this consultation response, contact Abigail Hall, Senior Policy Advocate, Regulated Industries Team on 020 7799 7934 or via email at abigail.hall@consumerfocus.org.uk

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can contact Consumer Focus via Text Relay:

From a textphone, call 18001 020 7799 7900

From a telephone, call 18002 020 7799 7900

Consumer Focus

4th Floor

Artillery House

Artillery Row

London SW1P 1RT UK

Tel: 020 7799 7900

Fax: 020 7799 7901

Media Team: 020 7799 8004 / 8005 / 8006