RPI-X@20: Summary of responses to Emerging Thinking consultation

1. Introduction

1.1. Our Emerging Thinking consultation in January 2010 set out for consultation a potential new regulatory framework for energy networks. In addition to a main consultation paper we published parallel consultation papers on embedding our financeability duty within the framework and on the advantages and disadvantages of introducing a third party right to challenge. The response deadline was 9 April 2010.

1.2. We received 27 written responses. This included 12 responses from energy network companies. Responses were also received from other industry stakeholders including RenewableUK, Consumer Focus, cross industry organisations including the Institute of Engineering and Technology (IET) and special interest groups such as the Campaign for National Parks. A full list of responses can be found at Annex A.

1.3. This note summarises the key messages received in relation to the different aspects of the new regulatory framework. The key points raised were:

- There was general support for the outcomes identified and the principles of an outcomes-led regulatory framework providing clarity on what network companies should deliver.
- There was also general support for richer and longer-term planning by network companies which would include scope for innovation and incorporate more effective engagement with customers and others.
- Most respondents set out that careful consideration would need to be given to detailed aspects of implementation to ensure the framework delivers the desired outcomes.
- While longer-term thinking was seen as critical to meeting the current challenges facing energy networks, there was some concern of a wholesale move to a longer price control period. Certain aspects of the control were highlighted as more conducive to this than others.
- The majority of respondents saw merit in applying regulation proportionately (focusing regulatory scrutiny on those who fail to deliver and provide a poorly justified business plan). A minority of respondents (particularly network companies) were concerned about the potential subjectivity involved, citing the need for objective guidance from Ofgem.
- A mixed response was received to the proposals for greater competition including tendering and facilitating energy service companies (ESCOs)[1]. The merits were recognised but many (including most network companies) identified aspects of the proposals that caused concern, particularly around requiring access to network company assets.
- The two aspects of the proposals that attracted the greatest concern related to the proposals on:
    - third party right of challenge; and
    - the financeability strawman.

[1] An ESCO is a company that provides energy services. In its most developed form this is a vertically integrated company that also invests in upstream network infrastructure.

2. Outcomes led framework

2.1. There was widespread recognition of the substantial challenges facing network companies. From this there was broad recognition that the RPI-X framework needed to be adapted although there was a mixture of views on whether the changes need to be built on the current framework or whether a wholesale change was needed. Those of the former view were concerned at the degree of change proposed in the elements of framework such as the financing proposals.

2.2. The outcomes we identified were considered appropriate and aligned with Government policy on sustainable development according to most respondents. There was also general support for clearly identifying outputs that the networks should deliver and many thought these should be underpinned by financial incentives although some noted that financial incentives should only be implemented once the outputs were robust. There was a widely held view that the framework should retain flexibility to reflect further changes.

3. Effective engagement and accountability

3.1. Respondents supported greater and more effective engagement with consumers and emphasised the need for this to be broad e.g. covering environmental interests and regulators such as the Environment Agency in relation to flood prevention/response. There was particular support for the idea that engagement should be network-led, with Ofgem engagement running in parallel.

3.2. There was concern that it may be difficult to secure meaningful engagement from a number of key stakeholders e.g. small consumers, generators and future consumers. It was therefore noted that Ofgem, consumer representatives and Government, would need to ensure the interests of these groups were taken into account.

3.3. Success of effective engagement was a key reason given for opposing a third party right to challenge (see below for more detail).

4. Incentivising efficient long-term delivery

4.1. Given the sustainability challenges, many responses supported the need for the regulatory framework to encourage longer-term thinking and reward innovative activities where an inherent risk of failure exists. There was a mix of views on the methods we consulted upon, particularly extending the length of control period.

4.2. There was support for longer-term outcome paths being included in the planning process. Opposition to all or most elements of the control being set over a longer period was based on a concern that lack of regulatory credibility would lead to increased risk and hence a higher cost of capital. Many set this against the current context of uncertainty about priorities and ways of meeting them. Some supported longer-term controls around specific programmes of work where this could provide greater certainty.

4.3. The innovation stimulus met with almost unanimous support in principle. Some concern was made around its implementation but in general a cross-sectoral stimulus that was open to third parties was supported (the latter as long as networks retained control and ownership of their assets). There was a feeling that innovation needed to also be supported by the main framework and further explanation was needed to show how investment would be treated.

4.4. There was general support, including from network companies, for richer business plans that enable the demonstration of innovative methods of delivery and longer-term business cases. Many felt that this plan should be prominent in assessing the base level of revenue with comparative benchmarking playing a lesser role.

4.5. Many also supported building proportionate regulation into the framework to strengthen incentives on network companies to deliver efficiently in the longer-term. Many saw advantage in extending the current different treatments of performance through the incentives to alter the regulatory burden facing a company who has developed a track record of efficient delivery. Other network companies were concerned at this proposal because of the perceived subjective judgement needed. The need for transparent and objective criteria for the way that we would treat companies was therefore suggested. Some highlighted that companies can change behaviour and any favourable treatment should be time limited.

5. Greater role for competition, cross sectoral solutions and changes to industry structure

5.1. Respondents recognised the benefits of greater competition e.g. through tendering in some circumstances. However, many also highlighted the need for careful consideration of where and how to apply any changes.

5.2. There was support, particularly among non-network respondents, for using enhanced competition to introduce new ideas e.g. from other industries with recognition that competition could lead to better value for money for consumers. However, most respondents argued that there was a risk of delay to investment at a time when such investment was particularly needed.

5.3. Network companies highlighted the benefits from the tendering they currently undertake and some argued that they were incentivised to tender work out where profitable under the current RPI-X framework. They emphasised that decisions on whether to tender should not only be based on cost grounds with many highlighting successful long-term commitments that they have entered into. Other issues raised included:

- dangers around new entrants cherry picking profitable opportunities;
- Ofgem expertise in identifying opportunities for additional competition and effective delivery options; and
- problems where enhanced competition leads to delivery problems.

5.4. A key issue for network respondents was that they did not view it as appropriate or legally possible to force them to dispose of their assets.

5.5. Respondents were generally supportive of fair third party access to the networks, discussed in the context of facilitating competition amongst ESCOs, but many network companies highlighted that they wanted to be involved where possible. Concerns were raised about any proposals to require networks to sell or lease their assets.

5.6. Respondents generally favoured the regulatory framework encouraging cross sectoral solutions but some highlighted the complexity and risk associated with this and highlighted the need to see further detail. IET argued that no single network company would have the relevant skills to deliver in isolation.

5.7. Most respondents did not see a need for changes to industry structure to facilitate the new framework. IET however felt the need for a wide ranging review of the distribution and supplier relationships and considered whether distribution owners should have a system operator role. Others argued that existing roles and responsibilities should be retained.

6. Embedding financeability within the framework

6.1. Respondents, particularly network companies, had concerns about the financeability strawman we consulted on. This included a number of new proposals that had not been preceded by a working paper so some of these issues may involve cases where clarification might help. The central argument that respondents raised is that the financeability strawman overall proposes changes that they perceive would not solve problems connected to the current approach and would be materially riskier for the network companies in a way that would necessarily require a higher cost of capital.

6.2. Particular concerns related to our proposals to:

- Place less focus on assessing short-run financeability at a regulatory control;
- Consider moving focus away from the ratios used by rating agencies - these were considered to provide important signals for investors; and
- Make changes in capitalisation policy and move to depreciation profiled on an economic basis – there were concerns regarding the cash flow implications of this.

6.3. Developing the return on regulatory equity (RORE) methodology used in DPCR5 was supported but a need to recognise its limitations and use other information for long-term financeability assessment was stressed.

6.4. Some respondents felt setting out long-term principles for the financeability assessment e.g. transparency would be useful.

7. Third party right to challenge

7.1. Centrica continue to argue in favour of suppliers receiving a formal role through a third party right to challenge. One network company (ENW) gave some support for fixing the appeal process into the price control timeline subject to certain key conditions, while another (NGN) remain undecided. However, otherwise there was widespread opposition to such a change from network companies. Consumer Focus provided a reserved response, emphasising that they needed to see more detail on how it would work before having confidence in the option.

7.2. Key arguments made in favour were built around better regulation (e.g. legitimacy and accountability) and the potential learning that could result from the CC process. Key arguments made against related to increased risk, delay to investment and diminution of the relevance of the regulatory control process and of Ofgem's powers. A number of respondents also pointed to existing mechanisms, such as the JR and the recent incorporation of the charging methodologies into industry codes which could help parties achieve the same outcomes. In addition, other reasons given include the difficulty of representing future consumer interests fairly in the process was highlighted along with Ofgem's track record of representing all consumer interests.

7.3. Most who looked into the detail, from either side of the argument, thought that the Competition Commission should be the gatekeeper, not Ofgem. Support was also clearly behind any third party not being able to cherry pick particular parts of the package. There was also support for the idea that third parties should face risk of having to pay proportion of costs of an appeal. Network companies felt strongly that suppliers should not be given the right even if other consumer representatives are considered as they perceive a clear clash of interests. More generally, a number of respondents suggested that only those that represented consumer interests should be allowed to make challenges of this nature. The majority of respondents suggested that if this option was to be pursued it would be preferable to do it with new legislation.

They also emphasised the need for strict criteria related to the process of referring cases.

Annex A: List of respondents to RPI-X@20 Emerging Thinking consultation

1. AMP Capital Investors
2. BG Centrica
3. Bury not blight
4. Campaign for National Parks
5. CE Electric
6. Chartered Institute of Water and Environmental Management (CIWEM)
7. Consumer council for Water
8. Consumer Focus
9. E.On
10. EDF Energy
11. Electricity North West (ENW)
12. Energy Networks Association (ENA)
13. GE Technology
14. Institute of Asset Managers (IAM)
15. Institute of Engineering and Technology (IET)
16. National Grid
17. Northern Gas Networks (NGN)
18. Orkney Islands council
19. RenewableUK
20. Renewables Energy Association
21. RWE npower
22. Scottish and Southern Energy (SSE)/Scotia Gas Networks
23. Severn Trent Water
24. SP Energy Networks
25. Utilicom
26. Wales & West Utilities (WWU)
27. Western Power Distribution (WPD)