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Hannah Nixon,
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Dear Hannah

Regulating energy networks for the future: RPI-X@20 - Emerging thinking

We welcome the opportunity to comment on the emerging thinking from your review of RPI-X@20.

Severn Trent Water is one of the largest ten privatised water and sewerage companies providing water to 7.4 million people, and sewerage services to 8.5 million people, in an area covering 21,100 square kilometres in the Midlands and mid-Wales.

We appreciate that as a water company, your review of energy network regulation is not directly relevant to our operations. We are, however, a network utility that is subject to RPI-X regulation and hope we can make a useful contribution on this basis. We have chosen not to comment on the detail of your proposals (which are outside our direct sphere of experience) but have instead focused on the principles underpinning them, particularly where parallels can be drawn with the water sector.

Overall

As we noted in our response to your earlier consultation on RPI-X@20 in April 2009, we welcome and support the rationale for the review. How to secure a sustainable future is a pressing issue for regulation, and network utility regulation with its strong focus on investment, in particular.

We too have been considering the role of RPI-X in this context. We share your proposition that whilst RPI-X is not broken – it is a tried and tested approach that has demonstrated real successes and secured investor confidence – it must adapt if it is to address the challenges of the future.

CONTINUATION

Shortly we will be publishing our own proposals on how regulators, Government and water companies will need to change if we are to ensure a sustainable future for the water sector. Our changes focus on allowing strategic, long-term and innovative approaches to be taken to address new and existing challenges. In particular, we propose a number of changes to Ofwat's price setting process aimed at providing greater incentives for innovation, accurate business planning and sustainable financing. There are many similarities with your own review we have highlighted them where appropriate.

An outcomes-led framework

We support your proposal to move from an inputs to an outcomes-led framework and believe that this is the direction future regulation in general should take. Our experience has been that too great a focus on detail in price setting and a prescriptive approach to subsequent monitoring, diverts both regulators' and companies' focus from strategic issues and limits opportunities to explore more innovative, long term approaches.

Effective accountability and engagement

We agree that it is appropriate for network companies and Ofgem to improve their engagement with stakeholders and that this would bolster the legitimacy of decision-making. This is also true of water companies and Ofwat. We believe there is scope for this, in both sectors, in two regards:

- The first is how the long-term outcomes that the sectors must deliver are decided, and in particular the role of Government and European Union (EU) Directives. Policy decisions and the extent to which EU Directives are transposed into UK law can have a significant influence on the outputs that companies are ultimately required to deliver and the price they charge. It is important that stakeholders are engaged in the process of determining desired outcomes and that the potential consequences for customers are understood and debated.

- Secondly, at an outputs level, both sectors need to consider how consumers can be more involved in the price-setting process. It is an issue common to both water and energy that price reviews impact on customers, but there is at present limited scope for them to influence its outcomes. This can in part be addressed by companies engaging with customers in formulating their business plans as you propose, but it is important that the overall framework provides sufficient flexibility for these views to have a genuine impact on the outputs that are to be delivered. Otherwise there is a danger that business plans become dominated by the need to meet statutory requirements with customer preferences being marginalised.

Incentivising efficient long term delivery

The incentives that RPI-X has traditionally provided for short-term efficiency gains now need to be augmented to encourage the behaviours required to address new challenges.

CONTINUATION

We share your view that to address future challenges, companies need to be incentivised to find delivery solutions that are sustainable and efficient for the long term. We welcome your proposals that:

- *The price control period should be lengthened for some outputs.* We agree that the time is not yet right to extend the price control period in its entirety. There is currently too great a volatility in a number of factors that affect costs, particularly in the present economic climate. However, it would be possible to define some outputs for a longer period, and the certainty this provides should facilitate longer-term planning and allow more sustainable solutions to be pursued.
- *Incentives should exist to encourage companies to adopt solutions that are likely to be lower cost over the longer term.* In many cases, adopting such solutions may present risks for companies, particularly if they rely on new technology or mean forgoing a short-term gain. Allowing companies to retain a fixed and predetermined proportion of the benefit of any saving made would enable more informed decision-making about whether to take such a risk. It is important that if companies are to make such long-term commitments the penalties for failure do not outweigh the potential benefits of success.
- *Equalized incentive rates for different types of cost.* We recognise that there is a need to provide equalized incentives for opex and capex in particular. A continued incentive for companies to pursue capital-based solutions in order to build their regulatory asset bases, may mean that more sustainable options are overlooked. We believe your approach of capitalising a fixed proportion of expenditure (regardless of whether it is opex or capex) should be considered by Ofwat at its next price review.

A greater role for competition in delivery

How market forces can best be employed to encourage efficient delivery is an issue pertinent to both energy and water. We note that you are considering the possibility of third parties tendering for large investment projects, and that this has obvious similarities to Ofwat's proposals for Infrastructure Service Provision (ISP). We have cautiously welcomed ISP as a way of exploiting more cost effective solutions to supply issues across companies' appointed areas, but believe that extensive consultation needs to take place about the detail of the provisions to ensure that potential benefits are realised.

Specific innovation stimulus

Greater innovation by companies is critical to the future sustainability of utilities. We are exploring ways that water companies could be incentivised to innovate more under Ofwat's existing RPI-X framework. We believe a simple but effective change would be to allow companies to retain the benefit of any cost-saving innovation at price reviews for a specified period, rather than passing it immediately to customers.

CONTINUATION

We are also interested in your proposals to establish a specific innovation fund, which echo proposals made by Martin Cave's independent review of competition and innovation in water markets, and those of a recent report by the Council for Science and Technology into innovation in the water sector. There is potential for both sectors to learn from each others' experience in developing such stimuli for innovation.

<u>Embedding financeability into the regulatory framework</u>

We support the view that it may be appropriate to differentiate allowed returns according to a company's circumstances. We believe that it is necessary to encourage additional equity investment in the utilities sectors to avoid gearing rising too rapidly. Excessive gearing will discourage innovation by making companies too risk-averse and will potentially expose consumers to greater risk. This suggests that there may need to be a higher rate of return for new investment. In addition, varying the assumed rate of return according to a company's actual gearing would incentivise continued equity participation in the sector.

We would be pleased to provide further information on any of the points we have raised.

Yours sincerely

Neil Corrigall
Regulation and Business Strategy Manager