RPI-X@20

Stakeholder working group on the length of the price control period

17 May 2010

Ofgem Offices, 9 Millbank, London

Summary

We published an RPI-X@20 working paper on our web forum on 7 May 2010 on *The length of the price control period,* to spur discussion and debate. The working paper set out a "straw man" showing current thinking on how we could introduce longer-term price controls. We held a discussion of the paper on 17 May 2010, which was attended by stakeholders representing consumers, energy network companies and energy suppliers across gas and electricity, transmission and distribution. The main points discussed are summarised below.

Participants agreed that the range of proposals set out in the working paper should bring a longer-term perspective to energy network regulation (e.g. use of longer-term business plans at price control review and a separate innovation stimulus building on the Low Carbon Networks Fund). They identified a number of ways in which an extension to the price control period could bring additional benefits:

- Exposing network companies to financial risks around their long-term costs could improve network planning decisions, in particular where there is uncertainty around future needs (e.g. volume of wind generation to connect in a specific location). However, several participants suggested that an extension to eight years would not be long enough to make a material difference to long-term network planning decisions, for which the relevant time horizon may be much longer.

- Participants from network companies identified practical examples of cases where five-year price controls deter companies from taking options (or even thinking of options) that would reduce long-term costs and instead lead them to options that minimise costs within the remainder of the five-year price control period. This problem may have been exacerbated in the past through differing incentives to control operating expenditure and capital expenditure. Participants supported a suggestion that, ideally, the incentives from the price control would encourage decisions based on 'whole-life' costing (e.g. using discounted cash-flow analysis (DCF) analysis to support a least cost net present value (NPV) approach).

- A longer price control period may make it easier to implement a new procurement strategy that delivers long-term cost reductions. Nonetheless, one participant highlighted that network companies would still need to test the value for money of their contracting choices periodically.

- Under a longer price control period, specific incentive schemes would be fixed for longer periods of time. This may render them more effective. Uncertainty as to the nature and calibration of incentive schemes that companies face in the future can impede their decision-making today.

- Conducting price control reviews less frequently could reduce the administrative burden and potentially improve company performance by reducing the distraction of the price control process on company management. In addition to the time taken for each price control review, some work on implementation of the new control has, in the past, not been settled until well into the first year of the new control period.

- There may also be a wider benefit from an increase in the length of the control period in supporting a change in mindset and encouraging network companies to think about things in a different ways. It may encourage the longer-term thinking that Ofgem is seeking from companies in their business plans.

One challenge with a longer-term approach is that the future energy mix, and an understanding on how best to meet environmental, security of supply and affordability challenges across the industry is still emerging. Participants suggested that greater cross industry collaboration and a clearer energy policy would help mitigate the associated risks to consumers.

There were mixed views on whether the current approach to price controls could adequately cater for investments that had long pay-back periods or that were relatively speculative. Several network participants suggested that although the Low Carbon Networks Fund was useful, its existence as a separate scheme highlighted deficiencies in the main incentive schemes in driving low carbon investments. One participant suggested an alternative view: a functional separation of higher-risk, longer payback, investments in to a separate scheme may be more appropriate than bundling them in with incentives on lower-risk, better understood, "business as usual" investments.

Against the potential benefits of a longer price control period, some participants were concerned that this could increase consumers' exposure to the risks of a network company receiving an overly-generous price control settlement.

Participants raised a number of points concerning the implementation of any longer-term price control, and in particular the straw man set out in the working paper:

- Participants identified the need for network companies to understand, and to be able to reflect in their business plans, the outputs that they need to deliver over a long timeframe (e.g. 15 years). But there was a suggestion that these could be kept at a high level, without commitments to targets for specific output measures.

- Participants agreed with the need to limit the scope of any mid-period review that takes place within a longer price control period. They had concerns about this turning into a full-scale review, defeating the purpose. Some questioned whether such a review is needed at all and suggested that a review should only take place in exceptional cases. An alternate view was that the costs of such a review may be relatively small in the overall context, and that the option value of allowing for this review could be significant to consumers.

- Some participants saw the mid-period review as a transitory measure. The risks around setting a price control for a longer period will be greater for the first review.

- There were concerns that the straw man set out in the working paper might increase price volatility within the control period (e.g. if adjustments to revenue allowances from the efficiency incentives were implemented year-on-year). This could create additional uncertainty for network users and impede their own pricing and investment decisions. A potential mitigation would be to allow companies some flexibility to re-profile their expenditure allowance over the price control period, subject to specified rules. Another mitigation would be through companies providing network users with better information on the likely future paths of prices.

- There may need to be some mechanism to allow a price control to adjust for "real price effects" during a longer price control period.

- There was a suggestion that Ofgem could include, at the mid-period review, a potential to re-open the price control if a company's actual costs are above or below some specified thresholds. Several participants cautioned that this could harm the incentives that companies face to control their costs.

- Participants raised concerns about Ofgem setting a cost of capital over a longer period of time. This could become out of line with the financing costs that companies face. Furthermore, consumers could suffer if the longer period led Ofgem to build in additional "headroom" to the cost of capital. Annual indexation of the cost of capital was raised as a potential solution.

- Participants were also concerned with measures that would increase the complexity of the price control framework (e.g. additional uncertainty mechanisms).

Whilst recognising the aim of exposing companies to longer-term financial incentives, there was discussion as to whether a different approach to that set out in the working paper might be taken:

- Some participants suggested that Ofgem should be looking at a much longer period of time (e.g. 20 years), at least for parts of a price control associated with asset management decision-making. This would rely on some form of agreement on a robust long-term asset management plan or policy. There would need to be mechanisms to protect companies from factors outside their control, and also to allow the asset management plan to be adapted over time.

- Participants identified that, as part of a business plan or asset management plan, companies might be able to make a case to Ofgem for spending additional money in the short term to deliver better value over the long term. However, several participants raised concerns about Ofgem "signing off" on specific asset decisions — this could lead to micro-management and excessive bureaucracy; it could also prevent innovation by tying companies to particular delivery approaches.

- Participants suggested that some areas of companies' activities, or specific projects, could be subject to longer-term funding and incentive arrangements even if other aspects remained at five years. Indeed, for some activities there may be no benefits of a longer price control (the gas distribution emergency service was suggested).

Finally, some participants raised the question of whether now is the right time to make the change to a longer price control period, given the other changes to the regulatory framework that RPI-X@20 may propose. An alternative approach would be to stick with five-year controls whilst other aspects of the new framework bed down.