Consumer Focus
Campaigning for a fair deal

Consumer Focus response to Ofgem's consultation *Regulating energy networks for the future: RPI-X@20 Recommendations*

September 2010

Regulating energy networks

Consumer Focus is the independent champion for consumers across Britain and for postal consumers in Northern Ireland. We operate across the whole of the economy, persuading businesses and public services to put consumers at the heart of what they do. We are a statutory organisation that works in a devolved setting, with work priorities varying across different parts of the country, by all working to common strategic goals.

Through campaigning, advocacy and research, we champion consumers' interests in private and public sectors by working to secure fairer markets, greater value for money, and improved customer service. We have a particular focus on the interests of consumers in markets that are 'designated' by Government as requiring additional consumer advocacy. Currently these include energy and postal service consumers. We also have a commitment to work on behalf of vulnerable and disadvantaged consumers, and a duty to work on issues of sustainable development.

Introductory comments

We provide detailed comments on all 12 of Ofgem's recommendations on the future regulation of energy networks, which it describes as 'Sustainable Network Regulation'. However, before this we would like to provide several introductory comments that, firstly, set out the most important points we would like Ofgem to consider and, secondly, provide some context for the more detailed comments that succeed them.

The changes that Ofgem is proposing are, if anything, evolutionary and not revolutionary. This seems to us to be entirely sensible. The RPI-X framework has a number of significant strengths, including encouraging increases in operational efficiency, and it is important these are not lost. The strengths of the RPI-X framework need to be built on and improved. More needs to be done in terms of focusing network companies on the needs of their customers rather than the regulator, improving the ability of firms to finance investment and to become more innovative.

Much of what Ofgem will need to do involves the apportioning of risk between network companies and end users. While it is fair that there should be a degree of 'risk sharing' between companies and consumers, Ofgem will have to get the balance right. In our engagement with future price controls this will be one of our main priorities. Ultimately, network companies cannot expect to pass ever increasing degrees of risk on to consumers. If network companies want to earn a reasonable return on their investments they must be prepared to manage the risk and uncertainty which accompanies this aim.

We agree that Ofgem should be looking to incentivise network companies with both 'the carrot' and 'the stick'; ensuring that good behaviour which meets customer needs is appropriately rewarded while at the same time ensuring that bad behaviour which increases costs for consumers, or even puts their needs at risk, is penalised. This seems to us to represent a fair and common-sense approach.

Perhaps the single most important innovation of the RPI-X@20 review has been the choice to make companies' business plans central to the delivery of agreed outputs. Network companies should expect to be challenged on their plans for future network services and investments, and to act on the views of their stakeholders. We believe that if companies are open and transparent with Ofgem and stakeholders their chances of having their plans understood and accepted will be greatly increased. This will benefit all parties and in particular consumers.

Response to Ofgem's recommendations

Objective

We agree with the two main objectives recommended by Ofgem. However, we do not entirely agree with the statement made by Ofgem that the two objectives are complementary. While it is true that this might often be the case, it seems clear to us that there will be instances when ensuring that network companies play a full role in the delivery of a sustainable energy sector will not be compatible with delivering long-term value for money for existing and future consumers. In such instances where these objectives are incompatible we would urge Ofgem to ensure that consumers, both current and future, receive long-term value for money. We should attempt to avoid any potential 'gold plating'.

While Ofgem discusses protecting the interests of existing and future consumers it does not mention in any great detail how it will make decisions where the interests of existing and future consumers become divergent. We would find it helpful if Ofgem could provide guidance on how its decisions will balance the interests of existing and future consumers where there is conflict.

Finally, we note Ofgem's attempts to simplify the price control process. We believe this is a worthwhile ambition and to a certain extent Ofgem has achieved this. However, the simplification of the process should not be the paramount concern. Ensuring that the process is effective in meeting the needs of consumers is most important.

Industry structure

We do not have many comments to make on this recommendation. However, we note that Ofgem might need to take preparatory steps to ensure that System Operator (SO) incentives, and the incentives contained within price controls, are compatible with providing long-term value for money for consumers.

For example, a constraint on a network could be tackled in several ways. These could include strengthening the network or altering the dispatch patterns of the producers or consumers that affect the constraint. The former approach would be incentivised under the price control regime while the latter approach would be incentivised under the system operator incentive regime.

This separation of alternative approaches to the same problem under different incentive schemes creates some risk that the network may pursue the option that brings it the highest reward, rather than the option that delivers greatest consumer benefit.

Enhanced engagement

The recommendations made by Ofgem to encourage enhanced engagement are very welcome. This should help ensure that the needs of consumers are better reflected in the business strategies and plans adopted by network companies. As has been stated previously, well-justified business plans which take account of stakeholder opinion are crucial to gaining external acceptance and support for network companies' operational and investment plans.

The principles for effective enhanced engagement are sound and we are pleased to see that Ofgem expects network companies to engage with stakeholders on an ongoing basis not just during price control periods. This should help foster better relations between different stakeholders.

However, we note that networks companies have been given a large degree of flexibility in how and when they will engage with their stakeholders. We do not believe that this is necessarily bad as long as there are strong incentives for companies to engage sufficiently. This should in no sense be a box ticking exercise. It is important that Ofgem considers the level and range of engagement that network companies have sought with their stakeholders and that it measures the impact this engagement has had on network companies' business plans. Furthermore, we believe that the following should help incentivise companies to communicate with stakeholders:

- Measures to allow for the fast tracking (or more intrusive forms of regulatory oversight) of price control decisions (the A,B and C categories at the proportionate assessment stage)
- Primary output incentives on customer satisfaction
- The greater use of reputational incentives
- In extreme circumstances, Ofgem having the ability to place licence obligations on companies who fail to engage with the threat of enforcement action

However, we believe this process could be further improved if Ofgem was to collect 'quality metrics' directly from stakeholders (questionnaires for example) that identify stakeholders' experience and best practice.

It goes without saying that for stakeholder engagement to be effective, engagement will have to be tailored to meet the needs of different stakeholders. In our experience, engaging with stakeholders bilaterally is almost always the most effective form of engagement. Ofgem and network companies should try their utmost to facilitate this form of stakeholder engagement. While the Price Control Review Forum should help different parties discuss more high level and strategic priorities, such engagement should not be seen as a substitute for bilateral meetings.

Furthermore, we find it very helpful if companies are able to provide figures of the financial impact of specific proposals in a form that is easily digestible, for example by relating it to a cost per customer. This will help consumers judge the value of proposals in companies' business plans. Ofgem should also encourage network companies, wherever possible, to provide evidence from actual customers (in the form of market research for example) to support specific business plan proposals.

Finally, there will inevitably be occasions where stakeholders' ability to engage will be constrained by limited internal resources. We would welcome more detail on what degree of engagement you expect from your stakeholders and when. For example the supporting paper states that Ofgem might ask for stakeholder responses to the initial sweep of network companies' business plans. We may struggle to find the resources to engage with such an approach and may not be alone in this. You will need to think carefully about how best to manage stakeholder engagement if you are to realistically deliver on some of your ideas in this area.

To help mitigate this problem we would find it helpful if different future price control determinations were staggered. This could also provide major benefits to consumers by allowing Ofgem to learn lessons from previous price control processes and implementing improvements more quickly. For this reason we are pleased that Ofgem is committed to a transparent process of review following and during price control periods.

Third party modification requests

We believe that the guidance document that Ofgem has provided should help clarify how and when third parties should endeavour to seek third party modification requests on Ofgem's price control decisions. However, we would say that the time allowed to put together a request for a modification to Ofgem looks a bit tight.

Nevertheless, we are not convinced that the issuing of guidance will mitigate concerns on Ofgem's role as 'guardian' of the process to refer requests to the Competition Commission. It is our opinion that there is a fundamental conflict of interest with Ofgem administering this function. It seems to us that this problem can only be resolved by changes to parliamentary legislation.

Outputs-led

We agree that the regulation and incentivisation of outputs is a more effective way of delivering sustainable network regulation than regulating company inputs. The six output categories are sensible as are the principles for setting outputs. We also agree that Ofgem should seek to streamline the number of outputs as this should make the price control process more effective and also reduce the chance of unintended consequences.

It is very important that the level of outputs which companies propose in their business plans is justified by the needs of consumers. This should be done, in part, by network companies undertaking consumer research and engaging effectively with consumer representatives (as well as Ofgem). We therefore welcome Ofgem's is commitment to undertaking qualitative and quantitative market research. We think that companies should endeavour to consider a range of options to meet agreed outputs. This will help stakeholders understand the different options available and their cost. As such we support the use of option analysis. We think that Ofgem should investigate the possibility of introducing an incentive on companies to develop new ways of measuring performance and providing new data. We also believe that the idea of peer reviewing business plans has some merits in that it should help ensure that companies' business plans incorporate consumer interests. The Consumer Challenge Group could be helpful in this regard.

We believe that it is important that Ofgem's proposals on 'secondary deliverables' does not lead to a form of micro management. However, we are hopeful that Ofgem has put in place measures to ensure against this potentially adverse possibility. For example, the guidance provided by Ofgem on the principles for the inclusion of secondary deliverables is important and seems sensible. It is correct that companies, not Ofgem, should propose secondary deliverables and those companies should also provide justification for their choices. We have a preference that secondary deliverables should relate to the delivery of intermediate outputs rather than focusing on delivery method ie input measurement.

We are glad that Ofgem will consider applying revenue payments in instalments following the achievement of secondary deliverables. This might help protect consumers from more risky investments. This is because it could help mitigate against the possibility that companies will take long-term investment decisions in highly uncertain conditions which could ultimately be more costly than is necessary for consumers as there will be a more 'guaranteed' revenue stream available to the company in question for that investment. The same applies to the potential use of 'use it or lose it' provisions and uncertainty mechanisms. However, Ofgem must be careful of levying penalties for failure to meet secondary deliverables. Ofgem must be absolutely sure that companies who do not comply with agreed secondary deliverables are only penalised where there has been a failure on the part of that company to meet the agreed outputs.

Retaining an ex ante control

We agree that it is still appropriate for energy networks to be subject to ex ante regulation; a compelling case for moving to ex post regulation has not been made.

Length of the price control

We certainly agree with Ofgem that extending the price control period to the length of asset lives would be too risky in terms of potential cost forecasting error. However, we are also unsure whether extending the length of the price control to eight years will materially increase the encouragement for network companies to behave more innovatively and ensure better long-term value for money. We believe that the other measures Ofgem is recommending will do more to achieve these aims. As such we are glad that Ofgem recognise that the decision to extend the price control is a difficult one and that this decision will be reviewed in future.

However, we accept that there could possibly be some incremental benefits to consumers by extending the price control by a few years. For example it should ensure that the regulated companies concentrate more on meeting the needs of their customers rather than negotiating with the regulator. It may also encourage slightly more innovative thinking from the networks as they will be able to take a longer-term view on how best to develop their assets.

In spite of this it is the mid-term re-opener which will prove crucial as to whether or not moving to longer term price controls will prove to be successful. Ofgem states that the re-opener will only apply to the agreed outputs where there has been a significant change in the energy industry or government policy (the greater take-up of electric cars for example). However, there are also statements in the supporting paper which refer to possible ex post efficiency analysis with presumably the possibility of claw backs. Ofgem should be absolutely clear at the commencement of a price control as to what events will trigger a revision of outputs and revenue. Networks will be wary of signing up to any open-ended ability to revise targets and it will therefore be crucial that the expectations of both consumers and networks are well managed.

Price cap regulation is expected to result in the regulated company being the beneficiary of any improvements in efficiency within the price control period where it makes those improvements, and its consumers will then benefit from those improvements from the start of the next price control period as they are reflected in efficiency adjustments and tougher targets. Moving to longer-term price controls may therefore alter the balance of risk and reward between networks and consumers, to the detriment of the latter. Ofgem will need to find ways to counterbalance this shift. This may take the form of implementing tougher initial targets. We do note though the use of within price control efficiency incentive rate adjustments which should help mitigate some of the potential drawbacks of moving to longer price control periods.

To ensure that Ofgem make the correct decisions it will need to ensure that it receives accurate information from regulated companies. As such the use of the Information Quality Incentive (IQI) and uncertainty mechanisms (or adjusters) will be important.

Proportionate assessment

Efficient cost analysis is very important for consumers. It is particularly important that business plans which demonstrate that expenditure will achieve outputs, take account of stakeholder opinion, and show alternative methods of delivery (something which is akin to benchmarking).

As stated in our introductory comments the 'carrot and stick' approach is sensible. Companies should have the intrusiveness of regulation reduced if they perform well and increased if they perform poorly. As such the ABC categories for price control oversight is a welcome innovation. However, if Ofgem has any doubts about whether a company should be placed in category A (the lowest level of regulatory scrutiny) then Ofgem should err on the side of caution and place the company in category B. There must be robust overseeing of network companies' business plans if consumers are to be adequately protected.

We are keen on 'spot checks' undertaken by Ofgem of different elements of network companies' business plans. This should provide an incentive for companies to ensure that their business plans are properly costed and should also minimise Ofgem's costs.

As stated in the previous section, the IQI seems a valuable tool, especially with the move to longer-term price control periods. We note that the experience of information incentives in helping set gas SO incentives has been largely positive.

Benchmarking is an absolutely essential tool for the regulator. We are in favour of making greater use of market testing techniques as it should better reveal the 'true costs' of providing different services, investments etc. It is important that the network company is responsible for designing and running any process rather than Ofgem, although Ofgem should take account of expressions of interest from third parties on specific company proposals in the enhanced engagement process.

Option to give third parties a greater role in delivery

We are entirely content with the use of third parties for the delivery of specific projects. Outsourcing is very common and can provide substantial benefits for consumers.

We would not expect to see Ofgem having any day-to-day involvement in networks' decisions on whether to use third parties; this kind of micro-management is unlikely to be proportionate. However, in extreme situations, where a network is materially failing to deliver on its agreed outputs, there may be a need for Ofgem to consider whether the network's approach to (and use of, or failure to use) third party involvement is appropriate. However, Ofgem should clarify the provisions available to the affected network company where there is potential disagreement on the use of third parties.

Incentives

The use of incentives is a key concept in price-cap regulation. We welcome Ofgem's decision to has retained this element of the RPI-X framework. As stated in our introductory comments, the use of both 'carrot' and 'stick' in terms of adjustments to allowed revenue is appropriate. We believe that adjustments to revenue during the price control period is welcome as the benefits of cost efficiencies can be passed to consumers without having to wait until the end of the eight year price control. It should ensure that there is less chance of regulated companies making windfall gains at the expense of consumers.

With agree with Ofgem's decision to equalise efficiency rates for both operational expenditure (OPEX) and capital expenditure (CAPEX) as this should stop any bias between companies initiating OPEX and CAPEX solutions. We also believe that the use of the balanced scorecard would help stakeholders engage in the price control process. It provides a clear summary of companies' relative performance.

We believe that it makes no sense to penalise network companies for increased costs which are outside their control, or to reward them for reduced costs likewise outside their control. This is not in consumers' best interests.

Therefore there is a need for the use of uncertainty mechanisms. However, Ofgem should ensure that uncertainty, and thus risk, is borne appropriately by companies. Uncertainty mechanisms should also only be used where they can benefit consumers ie to stop windfall gains. As such Ofgem's overriding principle for uncertainty mechanisms is sound.

We would certainly expect Ofgem to put in place some form of uncertainty mechanism related to inflation. While we are by no means experts on the relative benefits of different inflation indexes we believe that Ofgem's analysis on why it has decided to stick with the Retail Price Index (RPI) is sound. Moving to the Consumer Price Index (CPI) seems to represent an unnecessarily costly change at this stage.

We ultimately have a preference for financial rather than reputational incentives. Financial incentives are more appropriate for profit-seeking entities. Reputation incentives should not be seen as substitute for financial incentives, rather a complement to them. In addition, the value of reputational incentives is inherently reduced where dealing with monopolies given that customers cannot punish them by taking their business elsewhere.

Ofgem clearly shows there is a need to balance the level of the efficiency incentive rate. If it is both too high or too low it can damage the interests of consumers. Ofgem must be transparent in the decision it takes.

In the event of poor or non-delivery of outputs we have a preference for the use of enforcement action due to a company contravening its licence conditions in comparison with Ofgem giving responsibility to third parties for delivery.

While we think that it is acceptable to make ex post efficiency adjustments in cases where outputs have not been achieved, we do not believe that one principle that Ofgem discusses (that it will make adjustments where it believes companies have wasted money) is clearly robust. While the aspiration is clearly reasonable, it will be difficult to enforce any inherently subjective judgements. Ofgem should look to increase clarity on when it will make ex post efficiency adjustments.

We also have some concerns about how Ofgem will allow primary output achievement to be delayed in the short run to ensure value for money in the long run. The assessment seems to be too subjective. Ofgem should provide more clarity on how it will judge whether or not to make this type of decision.

Finally, there is a need to ensure incentives (both primary and secondary) are compatible with one another. It is also important that incentives with 'caps and collars' do not create perverse incentives at the margins.

Principles for ensuring efficient delivery is financeable

Arguably the toughest decision Ofgem will need to make in its future price control determinations will be related to the financeability of network companies' licensed activities. We recognise that there is a very difficult balance to be met between, on the one hand, ensuring that companies have the finance to be able to deliver their regulatory commitments, while at the same time, ensuring that customers are not financially exposed to potential inefficient and reckless behaviour on the part of the networks' management. We believe that Ofgem's principles on financeability should go some way to ensuring that the interests of customers and companies are equally taken into account. However, we would note that the more open and transparent Ofgem is when making its decisions related to financeability the easier it should be to get the support of all market participants and stakeholders. Of course the technical nature of much of these discussions will need to be accounted for when Ofgem seeks to engage on these issues.

We would also like to mention the decision of the Competition Commission, in its recent report on Bristol Water, that as long as the price control includes an ‘appropriate’ allowed return it would not be in the consumer interest to raise prices to enable a company to meet a financeability test. Ofgem should take heed of this judgement.

On the measures related to depreciation, we believe it is very important that Ofgem tries to match revenues to individual asset lives. The treatment of cash flows needs to be made on a case-by-case basis. The way depreciation is ‘loaded’ is also very important be it front or back loaded. Ofgem needs to consider intergenerational fairness in whether existing or future customers should pay the larger share of the return on investment (see our question on how Ofgem will make decisions where the interests of existing and future consumers are opposed above).

Innovation stimulus package

We believe that the two most important ways Ofgem is proposing to increase incentives to innovate are:

1. the commitment not to make retrospective adjustments to revenue for variations in costs if outputs are achieved (as long as the special circumstances where it will be adjusted are clear)
2. the potential for increased competition from non-network companies

We would prefer most innovative investment to be confined to being funded under the normal ex ante regulation process. The other recommendations that Ofgem have provided should help increase network companies’ incentives to invest in innovative solutions. We recognise however that for larger-scale and riskier investment projects there might be a need for a specific innovation fund/stimulus ie they must not be ‘business as usual’ investments. Nevertheless, Ofgem must do all it can to mitigate the possibility of ‘gold plating’.

Ofgem can help achieve this by enacting some of the points it sets out in the supporting paper. It’s important that firms, where possible, partially fund their innovation projects. This should provide the network companies with an equity stake in their projects and thus an added incentive in its success. It’s very important that Ofgem does all it can to stop the ‘crowding out’ of innovative investment. The crowding out risk would lead to increased costs for consumers. The composition and framework of the Independent Panel is key. Ofgem needs to provide transparency of appointments, decision-making guidelines etc.

Finally, intellectual property rights should rest with the consumer as ultimately they will bear a substantial portion of the risk of the investment. As such Ofgem should ensure that lessons learnt, even from projects which have ultimately failed, should be shared with the whole industry. While ordinarily this could be expected to lessen the incentives to innovate, as the money to fund these investments is being provided by end users the lessons learnt should still be disseminated to the wider industry so as to benefit customers in the long run.

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