RPI-X@20: Summary of responses to Recommendations consultation

1. Introduction

1.1. We received 29 written responses to the consultation, one of which was confidential. This included 10 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 English National Parks. A full list of respondents can be found in the table below.

Table – Written responses received to the Recommendations consultation

Name
1. CE Electric
2. Central networks
3. Centrica
4. Centrica storage
5. Consumer Focus
6. EA Technology
7. EDF Energy
8. Electricity North West (ENW)
9. Energy Networks Association (ENA)
10. English National Parks Authorities Association
11. ESBI energy international
12. Fuel Poverty Advisory Group
13. Health and Safety Executive (HSE)
14. Institute of Engineering and Technology (IET)
15. Jon Stern, City University
16. National Grid
17. Natural England
18. Northern Gas Networks (NGN)
19. Power Plus Communications
20. Renewable Energy Association (REA)
21. Renewable UK
22. RWE npower
23. Scottish and Southern Energy (SSE)
24. Scottish Power
25. Severn Trent Water
26. Transmission capital
27. Wales & West Utilities (WWU)
28. Western Power Distribution (WPD)

1.2. There was wide support for the RPI-X@20 review and the open and clear process that we had followed since its inception. Respondents also welcomed our commitment to the principles of better regulation.

1.3. Several respondents described the proposed framework as 'evolutionary' noting that the RIIO model largely built on the areas of policy developed during DPCR5. The main areas in which the package was seen as 'revolutionary' were financeability, third party role in delivery and third party modification requests.

1.4. General observations about the RIIO model included:

- Ofgem should not underestimate the resource needed to effectively implement this model, particularly as the Recommendations document suggested greater 'front loading' of work;
- further guidance is needed in certain areas (for example, business plans, proportionate treatment and mid-period reviews) to ensure stakeholders are clear on what is required and understand how Ofgem will treat certain behaviours; and
- a 'business as usual' approach is not an option.

1.5. A number of respondents noted that the impact of the RIIO model would only be evident once the recommendations had been implemented as part of the price controls.

2. Objectives of the RIIO model

1.6. There was widespread support from a range of stakeholders for the objectives of the regulatory regime with respondents recognising the importance of the objectives in helping to deliver a sustainable energy sector. However, one respondent suggested that the two objectives for the framework are not complementary and that, where there was a clash between the objectives, value for money for consumers should take precedence.

1.7. There were several comments on how we interpret the objectives including:

- energy network companies need to facilitate benefits in the energy industry more widely, including in generation and supply;
- in considering 'value for money' we should focus on actual delivery rather than measurement and reporting; and
- an additional objective would be needed related to ensuring network financeabilty.

3. Implementation under the current industry structure

1.8. There was general support that the current industry structure should be retained, with the arrangements kept under review. The review element was seen as important to ensure incentives remain aligned, e.g. between transmission and system operators.

4. Enhanced engagement

1.9. The proposals for enhanced engagement were broadly welcomed by many respondents, including Consumer Focus. A number of these respondents emphasised that it would be important for this type of engagement to be taken forward on an ongoing basis. Comments in favour of our approach set out that enhanced engagement:

- would be the most appropriate way to deliver for customers;
- was essential given the scale of challenges faced by networks;
- would help to ensure the needs of consumers are better reflected in the business strategies and plans adopted by network companies;
- would improve the legitimacy of the regime; and
- would provide more opportunities for stakeholders to influence price controls.

1.10. One respondent welcomed our recommendations for a role for government in the process while the HSE noted that they would be keen to proactively contribute.

1.11. A number of parties identified challenges that would need to be overcome for the proposed approach to work in practice and effectively interact with the rest of the regulatory regime. Issues included:

- the difficulties associated with getting all parties to engage and to effectively balance the interests of these parties;
- the need for effective information provision to allow the process to work well;
- the need for greater clarity with respect to the separation of engagement roles for Ofgem and the networks. Particular issues related to how 'good' network engagement would be rewarded and further structure around the engagement process to avoid wasteful and unnecessary contact with stakeholders;
- a concern that consumer views should not override the statutory obligations of network companies;
- the potential for enhanced engagement to assist in understanding levels of user commitment and inform the need for anticipatory investment;
- the need for open forums to be developed as part of Ofgem's engagement;
- whether fast-tracking could undermine enhanced engagement; and
- the potential to use aspects of negotiated settlement to inform decisions on particular areas of business plans.

5. Third party modification requests and right of appeal

1.12. In general there was support from non-network companies toward our guidance for third party modification requests. In particular, Centrica remained positive about the benefits of our recommendations highlighting that the proposals could encourage a step change in engagement. Another respondent noted that the proposals would help to shift the balance of power in price control reviews toward consumers while a further highlighted the importance of allowing parties full access to information to facilitate this. Consumer Focus welcomed clarification on the process that we would follow, provided by the guidance, but had outstanding concerns about Ofgem's role as gatekeeper of the process and the timings associated with any reference that was made to the CC. They had a preference for resolution of these issues through primary legislation.

1.13. Most networks companies remained opposed to the proposals on the basis of: increased uncertainty; the potential to delay investment; single issue requests allowing the price control package to be unpicked; and that is not necessary given enhanced engagement and Judicial Review. A number of network companies also questioned the credibility of our role as gatekeeper of the process given the pivotal role that we have in reaching a final price control decision. Both National Grid and Electricity North West also indicated that they favoured the introduction of a formal right of appeal through primary legislation which could be designed to mitigate some of the difficulties.

6. Outputs-led

1.14. There was general support for the outputs-led approach and the categories and principles for outputs that we proposed. In particular:

- several respondents highlighted the positive experience of outputs in DPCR5;
- the introduction of an environmental category was seen as a welcome step, with an environmental group suggesting that a specific category on the transition to a low carbon economy was needed; and
- the use of outputs was seen as beneficial in facilitating a more transparent and accountable regulatory regime.

1.15. However, one respondent expressed concerns that the use of outputs had not been fully justified while others suggested that an outputs-led approach could create a more interventionist regulatory regime. As such, one respondent suggested that the outputs should represent the minimum required dataset to assess network company performance. A number of respondents also expressed concerns about the way that the link between outputs and the longer term would be managed, with some respondents worried that this could lead to increasingly volatile charges.

1.16. In terms of implementing the outputs-led approach several stakeholders highlighted that a pragmatic approach was needed and we should not underestimate the challenge of developing credible outputs particularly given the time pressures associated with the front loading of work under the RIIO model.

7. Business plans

1.17. Network companies were generally supportive of the proposed content and role of the well justified business plans even though they were of the view that these business plans would represent a challenge. There was some suggestion that Ofgem needs to provide greater clarity to illustrate how business plans under the RIIO model will differ to those produced in the past. Network companies regarded the incentives to produce well justified business plans as important to facilitating longer-term delivery. One respondent noted that Ofgem would also need to alter its traditional viewpoint to consider approving alternative approaches.

8. Ex-ante regime and retention of RPI indexation

1.18. There was broad support across respondents for retaining an ex-ante regime and RPI indexation. There was some consensus that if a liquid market for CPI indexed bonds were to develop, we should revisit the question regarding the appropriate index.

9. Length of the price control and mid-period reviews

1.19. There was mixed support for the rationale of moving towards a longer-term price control. Some network companies, as well as other respondents, agreed with the benefits that were highlighted in the Recommendations consultation document. In particular, they noted that a longer-term control is one element of the package that will help to encourage longer-term thinking. One respondent even noted that there may be merit in extending the price control period beyond eight years. However others were less convinced, highlighting the additional risk it could create and the marginal impact it would have given that the length of the control is small compared to asset lives.

1.20. Of particular concern to a broad number of respondents was that greater clarity was needed on how the mid-period review would work and what it would cover. This was seen as essential should a longer-term control be introduced. Concerns focused on:

- the potential difficulties of preventing the scope of the mid-period reviewing widening which could undermine the move to a longer review period – effectively creating two four year reviews;
- whether the longer period would reduce the administrative burden given the potential variable scope and length of mid-period reviews;
- the absence of an obvious recourse for network companies if Ofgem chooses not to undertake a mid-period review.
- the lack of clarity on the options available to network companies if the result of the review is unsatisfactory;
- the impact it may have on charging volatility;
- the possibility that we would only consider certain elements of the package e.g. outputs at a mid-period review but that other elements of the package, for example, financeability could be affected by the changes implemented; and
- the potential for Ofgem to view outperformance as ill-defined outputs.

1.21. Several respondents highlighted that a move to a longer price control combined with the uncertainty in the energy sector as a whole, would require greater use of uncertainty mechanisms which could create additional complexity and charging volatility.

10. Proportionate treatment

1.22. There was wide support for the general principle of proportionate treatment. A number of respondents also welcomed the development of an assessment toolkit with a range of sensible tools and techniques. Some support was also expressed for retention of the IQI. However, the area of fast-tracking network companies sparked mixed views from respondents – generally around uncertainty about how it would work in practice. In this respect, clear and transparent guidance on how proportionate treatment would work in practice was considered to be important.

1.23. Several networks believed that there were merits to the fast-tracking proposal. However, a number of parties questioned whether Ofgem would be able to finalise its position in key areas at an early stage in the process. As such, they thought that Ofgem may need to revisit the settlements agreed with fast-tracked companies at a later stage in the process to ensure that the settlement reflected the final position agreed. Network companies therefore noted that they would need to carefully consider whether to agree to being fast tracked given concerns that they may be placed at a disadvantage as compared with simply agreeing their settlement at the end of the process. There were also concerns about Ofgem's ability to adopt a fast track approach in the first round of price controls given that we would have limited access to reliable output data.

1.24. One non-network respondent was strongly opposed to proportionate treatment on the grounds that it would set Ofgem and network companies against one another, damaging the industry, at time when the low carbon objectives require parties to work alongside each other.

11. Third party role in delivery

1.25. The proposals for a third party role in delivery tended to polarise views. Some respondents (including investors, technology companies and the HSE) highlighted benefits including, for example. The potential to expose innovative solutions. However, others noted that the achievement of these benefits would be dependent on the implementation of an effective framework by Ofgem. For example, Ofgem would need to ensure that 'ring-fencing' of specific areas does not increase costs on the wider network and that third parties cannot 'cherry pick' more attractive projects.

1.26. A number of network companies emphasised that they already used outsourcing in response to incentives under the current frameworks. Network companies were also largely unconvinced of the case made for Ofgem having the option of running competitive processes and highlighted particular concerns that Ofgem does not have the expertise either commercially or technically to perform this role. In addition, they questioned the way that we would maintain effective regulatory oversight of third parties.

1.27. Concerns were also expressed that once competition has been introduced this could lead to potential fragmentation, at a time where co-operation is critical for instance to deliver smart meters.

12. Incentives

1.28. The implementation of transparent rewards and penalties under the RIIO model was seen as desirable by a broad range of respondents to encourage effective output delivery and efficiency.

1.29. There was particular support for:

- the efficiency incentives (sharing factors) proposed in the RIIO model; and

- the equalisation of incentives for capex and opex.

1.30. Some respondents highlighted that care would need to be taken in the design and calibration of the different incentives to avoid driving perverse results. For example, it would be important to ensure that the outputs consumers really value are delivered rather than focusing on outputs potentially deemed less important to consumers. On the efficiency incentives, some respondents were concerned that symmetric sharing factors may not always be appropriate.

13. Financeability

1.31. Financeability was widely regarded as a key issue given the significant investment required to deliver a sustainable energy sector.

1.32. There was some support for the transparency of the finance principles, with the Recommendations document seen as a step forward from the strawmen considered earlier in the year. Consumer Focus also expressed support for the proposal to match depreciation to asset lives as did some network companies. However, network companies were largely opposed to our view that the financeability proposals would increase regulatory certainty, reduce investor uncertainty and reduce the cost of capital.

1.33. Two areas of the proposals attracted most comment – depreciation and the indexation of the cost of debt.

Depreciation

1.34. Issues raised included:

- there was widespread concern that a change in asset lives would reduce cashflows at a time when investment is needed. Given the potential for the regulatory framework to change in the future, there is no guarantee of future cashflows. As such, network companies disagreed with our conclusions that investors are indifferent to timings of cash flows suggesting that this could increase the cost of capital; and
- Ofgem’s rationale that current consumers are paying too much in electricity was not supported because pre-privatised assets have already been fully depreciated and therefore consumers are not paying for the assets that are currently in place.

Cost of debt indexation

1.35. Network companies were not in favour of indexing the cost of debt but instead favoured maintaining the ‘status quo’. Their concerns with respect to the proposed approach included:

- the application of an index too rigidly could be inconsistent with our financing duty which, they argued, should provide an appropriate cost of capital for the price control period;
- the use of a debt index might lead companies to make financing decisions that are not in the interests of consumers; and
- there would not be any headroom should there be future financial market shocks.

14. Innovation stimulus

1.36. The introduction of an innovation stimulus package was widely welcomed. The only concerns expressed related to the design and implementation of the mechanism which will be addressed at the next stage of the process of development. The separation of the stimulus between gas and electricity was seen as desirable, as well as consumers and shareholders bearing risk – not financiers.

1.37. One technology company expressed concerns that the competitive nature of the scheme may create barriers within the industry, potentially reducing sharing and timely learning while a further respondent was keen to obtain more clarity on the commercial incentives for networks to innovate.

15. Impact assessment

1.38. There were only two responses (network companies) on the impact assessment. The respondents recognised that seeking to quantify the benefit and costs of implementing the RIIO model is difficult, particularly before it has been used as part of a price control. Given the indicative nature of the impact assessment it was also seen as challenging to validate or challenge the figures.

1.39. Both responses challenged our assumption that the RIIO model would lead to an improvement in efficiency and reduction in the cost of capital relative to RPI-X. However, one respondent agreed that there are reasons to expect that the RIIO model would improve long-term efficiency. The other respondent believed there was a lack of quantification and that we overstated the benefits and understated the risks.