Promoting choice and value
for all gas and electricity customers

Smart Grids 2010
Sustainability & Regulation

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Ofgem’s statutory duties

- Independent regulator of GB gas and electricity industries
- Principal objective to protect the interests of **existing and future** consumers
  - Secondary duties include those relating to sustainable development

- For purposes of today focus on Ofgem’s role in **regulation of energy networks**
- £200bn required in energy investment by 2020 - £40bn in networks

Good news for the future grid

- Ofgem has a clear vision for the kind of network companies current and future customers need
- Vision driven largely by need to create a sustainable energy sector
- Network companies have a very important role to play
- Very large range of possible outcomes for shape/type of future grids
- We are making exciting changes to the way we regulate
  - 2010 price control review on electricity distribution (DPCR5)
    - Including £500m Low Carbon Network Fund
  - Root and branch review of incentive regulation (RPI-X@20)

Our vision for networks

- **We want** companies that will introduce new technology, commercial & operating arrangements as required to:
  - Play a full role in tackling climate change (as enabler and directly)
  - Provide security of supply
  - At value for money for customers
  - Taking into account the needs of future as well as current customers
- **We do not want** companies that wait to be told by the regulator/Government what they should do before moving away from BAU
- The regulatory framework shapes the network companies
  - But should not prescribe technologies or type of grid outcomes

Problem 1: Risk aversion

Impact:

- Network companies will not innovate unless there is a guaranteed short term reduction in overall costs
- We will only get change if Government/regulator mandates it
- Risk this comes too late to meet our environmental targets

Response:

- Since 2005
  - Innovation Funding Incentive sets aside small % of allowed revenues for R&D
- Since **April 2010** (DPCR5) - £500m Low Carbon Networks Fund for electricity distribution
- From **2013** (RPI-X@20) – concept extended to all energy network sectors and proposals for third parties to be able to compete for funds
- Beyond – may not need specific innovation stimulus if period of great uncertainty has passed and regulatory framework has evolved

Problem 2: Short term focus

Impact:

- Companies may cut costs at expense of long term security of supply
- May not put forward ideas to regulator that pay off in the long term if it makes them look inefficient in benchmarking
- Companies not required to plan with view to scenarios for the future

Response:

- From 2003 – interruptions incentive
  - Lagging indicator of network security
- From **April 2010** (DPCR5) – network investment output measures for electricity distribution
- From **2013** onwards (RPI-X@20)
  - Further output measures – 6 categories including related to enabling sustainable energy sector
  - Companies required to bring forward longer term business plans
  - Companies required to plan for a range of future scenarios
  - Possibly longer control periods

Problem 3: Bias to capex solutions

Impact:

- Companies' short term profitability impacted less by an overspend on capex than on opex
- Companies choose to do capex (replace/reinforce assets) rather than opex (maintain assets/find ways of shifting load)
- Further barrier to companies playing an enabling role in tackling climate change

- **Response:**
- From **April 2010** (DPCR5) – "equalised incentive rate" for electricity distribution companies
- From **2013** on (RPI-X@20)
  - Equalised incentives extended to all network sectors
  - Change in approach to benchmarking (totex)

Problem 4: Not customer focused

Impact:

- Networks tend to focus on Ofgem rather than customers
- Get out of touch with what customers want and how this is changing
- Fail to meet needs of new customers like DG

Response:

- From **April 2010** (DPCR5) – broad measure of customer satisfaction with financial rewards and penalties
- From 2013 (RPI-X@20) onwards:
  - Customer satisfaction incentives
  - Requirement to demonstrate customer engagement in business plans
  - Threat of having to tender out part of service if not meeting customer expectations
  - (Possibly) customer groups given right to refer price control to the Competition Commission

In summary

- Network companies have a vital role to play in delivering a sustainable energy sector
  - The regulatory framework can give them the incentives to play a full part
  - Without prescribing either the technology or the type of future grid the companies should create
- In DPCR5 2010 we made significant steps to ensure we are regulating appropriately
- Conclusion of the RPI-X@20 project, and next reviews for Transmission and Gas Distribution likely to bring through further, more profound changes
- We are already seeing important changes in the behaviour of network companies

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