

# Reforming Network Regulation

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**Ofgem's main objective is to protect the interests of present and future energy consumers.**

**A key part of this role is the regulation of the network monopolies in gas and electricity.**

As the threat of climate change has become clearer, Government energy policy has changed to deliver environmental improvements for consumers to help drive down harmful carbon emissions.

Ofgem's Project Discovery estimates that network investment will make up around £45 billion of the £200 billion needed to secure energy supplies and ensure Britain meets its climate change targets by 2025. Not only is there a need to invest, but there is a great deal of uncertainty over how Britain will make the transition to a low carbon economy. This is why Ofgem's review of

network regulation is seeking to encourage network companies to become more flexible and innovative so they can quickly adapt to meet the demands of customers and a low carbon economy.

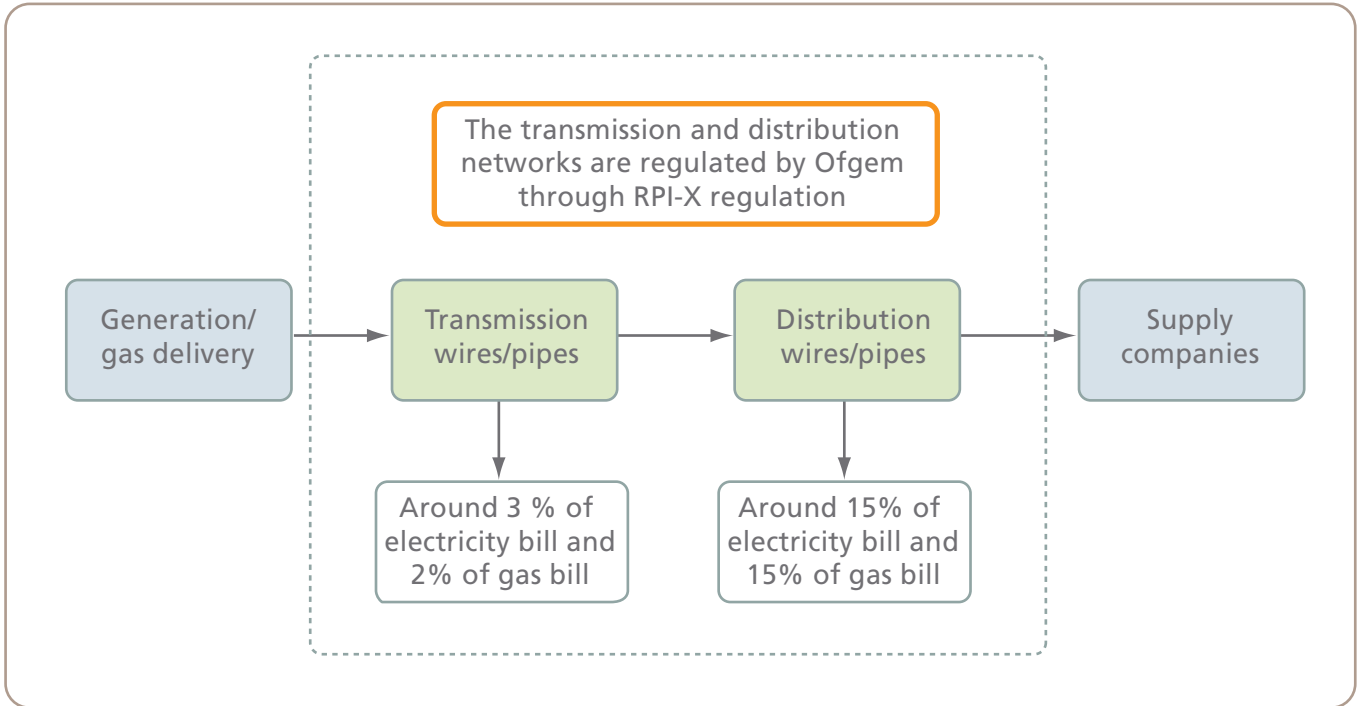
Against this backdrop of fundamental change, Ofgem is undertaking a detailed review of energy network regulation which has been based on an 'RPI-X' price control approach for the last 20 years.

## ► What parts of the industry does Ofgem regulate?

Ofgem regulates the monopoly companies which run the onshore GB gas and electricity networks (the pipes and wires). Through setting price controls Ofgem has a direct

influence on the network charges which account for around 17-18% of average household energy bills.

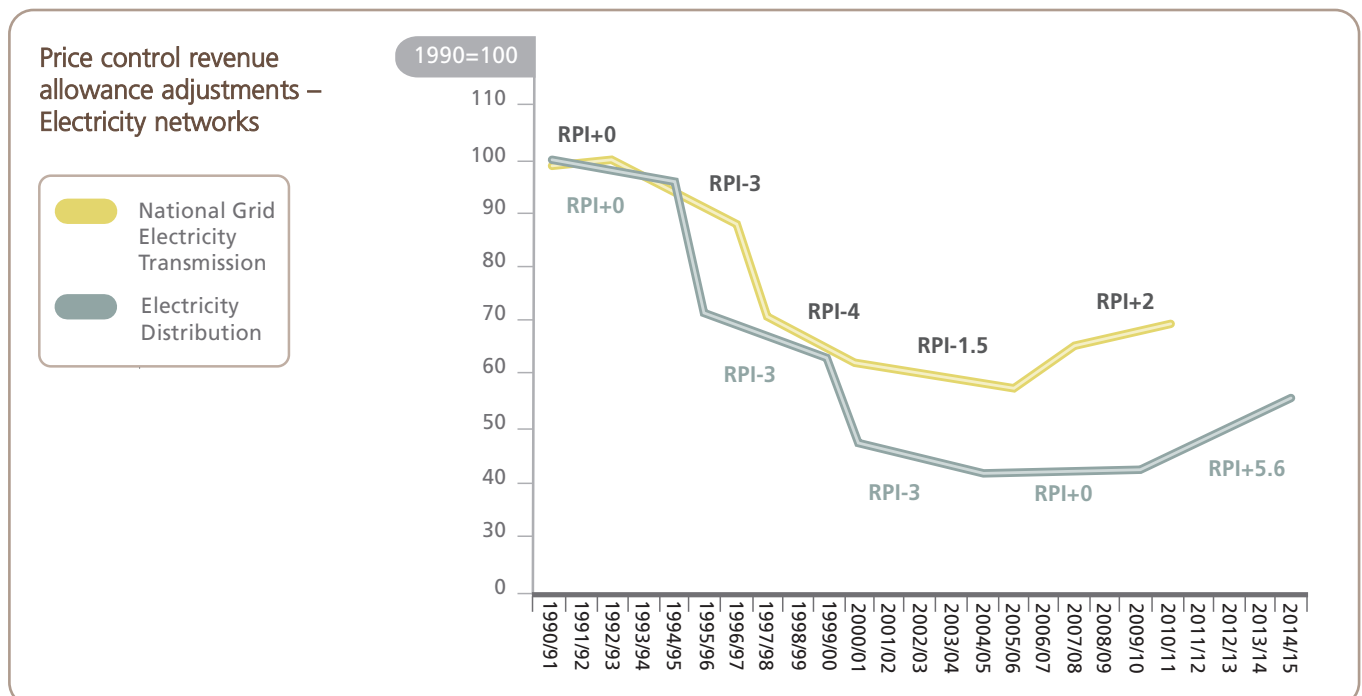
## ► Ofgem’s regulatory role



## ► Performance of existing network regulation

RPI-X regulation has served energy consumers well since privatisation. Price controls have driven down the costs of energy networks for consumers, whilst improving service and reliability through higher levels of investment than before

privatisation. For example, there has been a 30 per cent reduction in the duration and number of local power cuts on networks between 1990-2009.



## ▶ Delivering a safe, secure and low carbon energy sector

Over the last series of price controls, the emphasis has changed from concentrating mainly on delivering efficiency gains to:

- replacing ageing infrastructure
- connecting renewable generation, and
- connecting new gas importation infrastructure.

As a result, the last four price control settlements have delivered over £20 billion worth of investment in Britain's

electricity networks. There has also been significant investment in the gas distribution and transmission networks, including a recent programme to replace cast iron mains to meet revised safety requirements.

Greater emphasis has also been placed on improving service quality and sustainability. The latest electricity distribution price control will see up to £500 million available for network companies to run trials and innovate in preparation for a low carbon economy.

## ▶ Regulatory certainty

Another success of network regulation is that it has been transparent and open. This is important as regulatory certainty helps build investor confidence allowing energy companies to

fund their businesses for less in financial markets and this helps keep network costs to consumers as low as possible.

## ▶ Ofgem's Emerging thinking consultation

The current price control arrangements, while not broken, are not the best way forward for meeting the uncertain challenges of delivering a low carbon economy.

This is because the current arrangements do not:

- encourage network companies to engage effectively with their consumers
- focus companies on long-term requirements, particularly those related to delivering a sustainable economy

- promote the levels of innovation needed if ideas like smart grids are to become a reality, and
- deliver simple, effective regulation.

Ofgem has published its emerging thinking consultation on a possible new regulatory framework.

Ofgem's aim is to transform how network companies run their businesses so they can make a bigger impact in delivering a low carbon economy while ensuring that investment is delivered cost-effectively for consumers.

## ▶ The network company of the future

The network company of the future could:

- play an active role in delivering a sustainable energy sector, for example, by working to encourage the emergence of innovative energy service companies focussed on reducing carbon emissions from energy use
- strive for continuous long-term improvements in performance and efficiency, by showing flexibility, innovation and initiative

- develop solutions that offer best value for consumers both now and in the future, and
- manage uncertainty by taking on risk where appropriate, for example, prudently investing to meet the potential needs of future consumers.

### ► Creating the right regulatory framework

To explore how to create the network companies of the future Ofgem is consulting on ideas which would change the way it sets price controls. These include:

- some elements of the price controls might be set for longer than five years to encourage a longer term focus and more investment and innovation in energy networks
- better incentives might have the potential to kick start more investment in sustainable energy services, encouraging networks to identify when and where infrastructure and new technologies, such as smart grids, are needed
- delivery of large network projects may be opened up to competition to keep costs low for consumers and stimulate innovation through greater use of tendering, providing this does not jeopardise timely delivery
- looking at greater rewards for innovation and investment to support a low carbon economy, for example, through the establishment of an innovation investment fund open to all network operators and third parties, and
- streamlining the process for the most efficient companies with the best customer service through more targeted regulatory scrutiny whilst maintaining close regulatory oversight of the less efficient or poorly performing companies.

### ► Financing

Ofgem will continue to allow companies to earn a return on a defined regulatory asset value but is consulting how to develop a clearer and more transparent methodology on the

core elements of the financing package including the cost of capital, depreciation, the regulatory asset value and the assessment of financial ratios.

### ► Implementation

Ofgem's emerging thinking document will be subjected to an in-depth three month consultation process. Ofgem will also be continuing to run a series of workshops and seminars to support this consultation.

Once the project is completed the recommendations will be used when setting the next Transmission Price Control and Gas Distribution Price control, which are both due to start in 2013.

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