



Commission for Energy Regulation

An Coimisiún um Rialáil Fuinnimh

**Proposals for the Economic Regulation of the  
Gas Safety Supervisory Body and any  
Electrical Safety Supervisory Bodies to be  
designated by the Commission**

**A Consultation Document**

**CER/08/050**

**14<sup>th</sup> March, 2008**

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# 1 Introduction, Background and Consultation

## 1.1 Introduction

The Energy (Miscellaneous Provisions) Act 2006 (*“the Act”*) granted the Commission for Energy Regulation (*“the Commission”*) the separate functions for the regulation of the activities of electrical contractors and gas installers with respect to safety. The Commission is currently involved in the process of designing and implementing the new separate and statutory-backed regulatory systems for electrical contractors and gas installers in line with the provisions of the Act (*“the new regulatory systems”*).

To that end, the Commission has presented its decision on the high-level design of the new regulatory systems and is engaging in the process of determining the detailed rules to apply for each system (through the development of the “Criteria Documents”). Further detail on these is presented in Appendix 1.

The Act provides the Commission with the power to designate bodies to act on its behalf (in separate capacities) as follows:

- for the regulation of electrical contractors, the Commission may appoint a party or parties to act as an Electrical Safety Supervisory Body<sup>1</sup>; and,
- for the regulation of gas installers, the Commission may appoint a single party to act as Gas Safety Supervisory Body<sup>2</sup>.

The Gas Safety Supervisory Body and any Electrical Safety Supervisory Bodies designated (together Safety Supervisory Bodies or “SSBs”) shall each be responsible for the operation and management of a registration and monitoring scheme for gas installers and electrical contractors registered with it and such other activities as the Commission may specify further to the Act.

The Commission is to engage in a “Designation Process” to appoint any such SSBs. This process is discussed further in Appendix 1.

The Act also contains provisions relating to the economic aspects of the new regulatory systems and any SSBs designated for either such system. These relate to, among other things, the approval of the fees/charges of an SSB by the Commission and the recovery of an SSB’s costs incurred further to it carrying out its functions further to designation.

The Commission is presenting this Consultation Document which sets out its proposed framework for economic regulation within the new regulatory systems (*“the economic framework”*).

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<sup>1</sup> This is provided for under Section 4(9)(D)(1) of the Act.

<sup>2</sup> This is provided for under Section 13(9)(F)(1) of the Act.

### 1.1.1 Purpose and Scope of the Consultation

The purpose of this Consultation Document is to present the options, and the Commission's proposals, for the high-level design of the economic framework. In doing so, the Commission is seeking to elicit public and industry comment on the proposed approach of the Commission to the economic aspects of the new regulatory systems, and, in particular, the regulation of any SSB designated.

The Commission is presenting its proposals on the basis that these shall apply for an SSB designated for either role – i.e. to act as the Gas Safety Supervisory Body or an Electrical Safety Supervisory Body. This is on the basis that the provisions of the Act are identical with respect to the economic regulation of an SSB in the context of the new regulatory systems for either gas installers or electrical contractors.

Further to the conclusion of the consultation process, and the consideration of comments, the Commission will publish its decision on the economic framework.

### 1.2 Structure of the Consultation Paper

This consultation paper is structured as follows:

- Section 2 outlines the legal obligations (arising from the Act) and the policy determinations and challenges which will govern and influence the development of the economic framework;
- Section 3 presents the Commission's proposals with respect to the objectives for, and the principles to underpin, the economic framework. It subsequently presents the proposed high-level approach to the economic regulation and the key elements of that approach;
- Sections 4, 5 and 6 presents the Commission's consideration of each of the key elements of the economic framework as identified in Section 3; and,
- Section 7 presents the Commission's overall proposed economic framework and its conclusion in that regard.

### 1.3 Consultation Response and Next Steps

In presenting this paper for consultation, the Commission invites comment on its proposals and, in particular, its proposals with respect to its overall proposed economic framework (Section 7). Responses should be submitted, preferably in electronic format, in accordance with the following details:

<b>Contact/Email:</b>	<b>Electrical Industry Respondents:</b> <b>Garrett Fitzgerald,</b> <i>Manager, Regulation of Electrical Safety</i> <a href="mailto:gfitzgerald@cer.ie">gfitzgerald@cer.ie</a>	<b>Gas Industry Respondents:</b> <b>Eamonn Murtagh,</b> <i>Manager Gas Safety</i> <a href="mailto:emurtagh@cer.ie">emurtagh@cer.ie</a>
<b>Postal Address:</b>	<b>Commission for Energy Regulation,</b> <b>The Exchange, Belgard Square North, Tallaght, Dublin 24</b>	
<b>Closing Date:</b>	<b>5.00pm on 14<sup>th</sup> April 2008</b>	

## **2 Legal Obligations and Policy Determinants of the Economic Framework**

### **2.1 Section Overview**

This Section presents:

- the legal obligations placed on the Commission with respect to the economic framework; and,
- policy decisions made by the Commission with regard to the new regulatory systems which are of direct relevance to the economic framework and key challenges identified with respect to the specific nature of the role of an SSB.

The above will be key influences in the Commission's design and operation of the economic framework.

### **2.2 Requirements of the Act**

The Act requires the following with respect to the economic regulation of an SSB<sup>3</sup>:

1. The tariff of fees and charges imposed by an SSB relating to the services provided (further to their designation) shall be subject to the approval of the Commission;
2. All expenses and costs incurred by an SSB in carrying out its functions further to the Act shall be defrayed by the Body out of funds at its disposal which are obtained in accordance with the fees and charges imposed;
3. The Act furthermore provides for the Commission to make a contribution to the costs of any SSB designated to facilitate it in establishing and carrying out its functions;
4. In determining the number of SSB to designate for the electrical safety regulatory system, the Commission shall have regard to the costs likely to be incurred by (1) the Commission in carrying out its functions under the Act and (2) by final customers.

The above requirements must inform the policy decisions of the Commission with respect to determining the economic framework.

### **2.3 Policy Decisions Influencing the Economic Framework**

#### **2.3.1 Competition**

In considering the most appropriate approach to regulation, the Commission has considered whether competition, of some form, could play a role in revealing more complete or more accurate information with respect to the costs

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<sup>3</sup> These requirements emanate from Sections 4 and 13 of the Energy (Miscellaneous Provisions) Act 2006.

of undertaking the designated function and/or putting downward pressure on costs.

The Commission has taken the view that it is appropriate to embark upon a competitive process for the appointment of any SSBs (via the Designation Process). This will aim to ensure that the Commission appoints the most suitable parties for the roles of SSB within either of the new regulatory systems based on competitive bids, which will include an element of competition on an economic basis. Such parties will be appointed for an initial 7 year term.

In considering its approach to the selection of parties to act as SSB, the Commission shall, further to the requirements of the Act, operate a Designation Process that considers, on a competitive basis:

- the proposed costs of parties; and,
- the proposed fees/charges of parties; and,
- the proposed “establishment cost” contribution required by the parties in their proposed undertaking of the designated function.

This is discussed further in Section 7.

### **2.3.2 “Not for Profit”**

The Commission, in its decision papers on the Vision for each of the new regulatory systems, presented its decision to require that any SSBs are to be designated and regulated on the basis that they are to operate on a “not-for-profit” basis.

Profit, in this sense, refers to any surplus which remains after the costs of the SSB in carrying out its designated functions have been deducted from its revenues arising from those functions.

In applying this policy decision to the new regulatory systems, the Commission sets out the following interpretation of not-for-profit:

- SSBs shall be regulated on the basis that revenues shall be adequate to cover the costs of undertaking its designated functions;
- Where there is any profit or surplus of revenue above such costs, that surplus shall not be distributed to any shareholders of the SSB and the SSB shall not be entitled to distribute the surplus to any third party unless expressly approved by the Commission;
- Any such surplus shall be required to be used for the purposes of the new regulatory system and in accordance with such directions/requirements as specified by the Commission;
- In such instances, it is envisaged that any such surplus would be used for, among other things, the following:
  - contributing to the costs of undertaking its designated functions;
  - contributing to such other ancillary activities as approved by the Commission. This may include allowance for the surplus to be

contributed toward the cost of activities which are not undertaken directly by the SSB but which are for the benefit of the new regulatory systems (for example: promotion and public awareness of public safety).

The key aspect of its not-for-profit nature is that profits are not retained by shareholders. Therefore, the SSB will not have the objective to maximize profits for shareholders. However, in the Commission's view, even if a company operates on a not-for-profit basis, there is no reason why it should not see rewards for good performance and incentives to eliminate poor performance.

### **2.3.3 Balancing Safety and Cost**

While the principles of, and methodologies for, economic regulation are fairly well established in other regulated industries, there are relatively few circumstances where it has been applied to a scheme designed to improve safety.

The Commission is of the view that the primary objective of an SSB is to deliver upon the requirements placed on it concerning electrical or gas safety and associated with its designated function. However, it is clear that some consideration must be given to the economic delivery of such services and consideration must therefore be given to finding the appropriate balance between the challenges of maximising safety and minimising cost.

Further to the requirements of the legislation as presented in Section 2.2, the Commission is of the view that it is appropriate to provide for a level of revenue to facilitate the recovery of the costs of an SSB. However, the Commission does not believe that it would be appropriate for it to provide allowances to cover **any** costs incurred by the SSB.

Were this to happen, it is doubtful whether the SSB would have **any** incentives to operate efficiently and there would be a concern that charges to gas installers and registered electrical contractors would be higher than necessary, which might discourage them from participating in the scheme.

Hence, the Commission shall provide for the recovery of "efficient" costs of an SSB in undertaking its activities further to designation.

## **3 Overview of the Economic Framework**

### **3.1 Section Overview**

This Section presents the Commission’s consideration of, and its proposals on, the following:

- the Commission’s objectives and principles with respect to the design and operation of an appropriate economic framework;
- the high level approach to economic regulation;
- the key components of a framework for economic regulation.

In examining the above, this shall provide the background and context to a more detailed discussion of the options for the economic framework, and presentation of the Commission’s proposals in that regard, in Section 7.

### **3.2 Commission’s Objectives and Principles for Economic Regulation**

The overall regulatory objectives for the new regulatory systems, from a safety perspective, are articulated in the Commission’s Vision documents (see Appendix 1).

This presented the following objectives for the new gas and electrical safety regulatory systems respectively:

#### **Regulatory Objective for Electrical Safety**

*“To protect the safety interests of customers with respect to electrical installation activities through creating a suitable regulatory system which provides for electrical works to be carried out, tested and certified in compliance with the appropriate technical rules/standards.”*

#### **Regulatory Objective for Gas Safety**

The overall objective of the Natural Gas Safety Framework is:

*“To ensure that adequate measures are taken to protect life and property from the dangers associated with natural gas by ensuring that gas related activities within the scope of the Commission’s responsibilities are carried out in a safe manner, which takes account of and mitigates against the risks associated with the storage, transportation, supply and use of gas”*

Within this overall objective, the Commission will:

*“Ensure that all categories of ‘gas works’ designated by the Commission are only undertaken by competent gas installers who are registered, and subject to ongoing regulation and inspection, by the Gas Safety Supervisory Body appointed by the Commission.”*

The overarching consideration in terms of operational outputs shall be the delivery, on the part of the SSB, upon its obligations with respect to safety with regard to its designated functions. These shall be judged through reporting (supported by audit and inspection by the Commission) on the SSB's performance with respect to the requirements specified further to:

- the Terms and Conditions of Appointment;
- the provisions of the Criteria Document (for example, the approved Annual Audit and Inspection Programme of the SSB);
- its proposals as part of the Designation Process (to the extent that these are binding); and,
- any other relevant requirements (pursuant to the Act, other legislation or directions issued by the Commission).

It is equally important that the objectives and principles of the economic framework are articulated by the Commission and understood by the industry. These are critical in determining the approach of the Commission to the economic framework and the subsequent operation of that framework.

In that regard, the Commission proposes the following **Strategic Objective, Operational Objectives and Principles** with respect to the economic framework for the new regulatory systems. These are presented below.

### ***Strategic Objective***

The Commission is to design a method of regulating an SSB which leads to the greatest level of benefit with respect to safety, in line with the requirements specified by the Commission, and the most efficient delivery of that benefit.

### ***Operational Objectives***

The Commission is to put in place an economic framework which seeks to ensure that the new regulatory systems, as operated by the SSBs, are:

- **Effective:** The economic framework supports the maximisation of the benefits associated with the new regulatory systems and that service quality is maintained at all times;
- **Robust, Self-Financing:** The economic framework provides for the SSB to recover the costs of it undertaking its designated functions and therefore, provides for a sustainable model for the operation of the new regulatory systems which does not require subsidy or support from external sources and provides for the direct recovery of the costs of the new regulatory systems from the system users; and,
- **Efficient:** SSBs should face incentives to deliver reasonable cost savings and to operate as efficiently as possible, whilst delivering on the specified requirements of the Commission, and, in achieving this, to consequently deliver reasonable levels of costs to customers.

## ***Principles***

The Commission has determined that the economic framework must adhere to the following principles:

- **Legitimacy** – consumers (including, in this instance, the public, gas installers and electrical contractors) having confidence that the regulatory system will protect them;
- **Transparency** – SSBs and consumers knowing “the terms of the deal”;
- **Proportionality** – Any method of regulation needs to be proportionate – i.e. it should seek to minimise the costs of regulation while ensuring the full benefits of the scheme are realised;
- **Necessity** – the degree of regulation should be driven by necessity and by the desire to reduce the burden of red tape where possible; and,
- **Regulatory Certainty**– the approach employed should be consistent, credible and must make clear the responsibilities, and entitlements, of the various parties involved in the operation of the economic framework.

### ***3.3 Design of the Economic Framework***

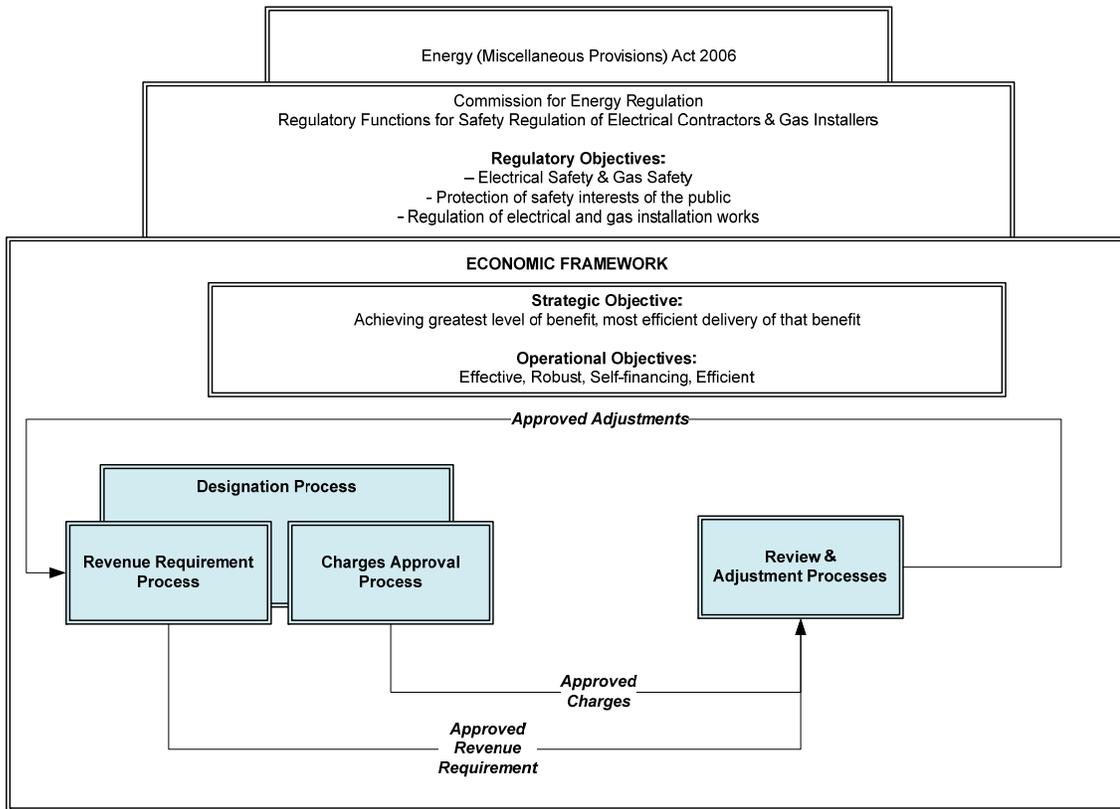
In achieving the above Strategic and Operational Objectives of the economic framework in line with the Principles, the economic framework will be required to provide for the following:

1. the determination of the appropriate costs of an SSB which are to be recovered through its expected income from fees and charges (determining the “Revenue Requirement”);
2. the determination of the levels of fees/charges which must be applied to services provided in order that the Revenue Requirement may be met (i.e. those costs recovered); and,
3. the review and adjustment of the above in order to ensure that any imbalances (from cost over-runs or cost savings, lower than forecast volumes of activity, etc.) are addressed in the appropriate fashion.

In order to present the economic framework which provides for the above, the Commission has determined that the following three key processes need to be developed:

1. the process for determining the level of revenue each SSB should be allowed to recover through charges (“**Revenue Requirement Process**”);
2. the process for developing, and approving, the fees/charges to be applied by an SSB (“**Charges Approval Process**”); and,
3. the processes for the review and adjustment of costs and charges further to the outturn performance of the SSB in order to ensure that the system remains in line with the delivery of its objectives (“**Review and Adjustment Processes**”).

The diagram below presents an overview of the economic framework proposed:



The next sections of this document examine the Commission’s proposals with respect to each of the above processes.

## **4 Revenue Requirement Process**

### **4.1 Section Overview**

The Revenue Requirement shall provide for the recovery of the “efficient” costs of the SSB in undertaking its designated function.

As discussed in Section 3, a critical part of the economic framework involves determining the Revenue Requirement of an SSB – i.e. the level of revenues that should be provided to an SSB in order to cover the level of Fixed and Variable Costs that it would be expected to incur in efficiently performing its designated function.

The objective of the Revenue Requirement Process is therefore to determine what the efficient level of costs are which are to be covered by the revenues of the SSB. The determination on that Revenue Requirement for the SSB (for a specified period) shall determine the level of revenue required to be obtained through the fees/charges applied to users of the services provided by the SSB. This in turn shall be a key determinant of the levels of fees/charges to be applied by the SSB (and as discussed in Section 5).

This Section of the paper:

- examines the overall considerations in determining an approach to the Revenue Requirement Process (Section 4.2); and,
- presents the Commission’s proposed methodology for determining it (Section 4.3).

### **4.2 Approach to Revenue Requirement Process**

In designing the Revenue Requirement Process, it is important to consider the following factors:

1. the role of the Commission and the level of Industry-involvement in the Revenue Requirement Process;
2. the ring-fencing of costs emanating from the designated function; and,
3. the period for which the Revenue Requirement is to be determined.

These are discussed below.

#### **4.2.1 Commission and Industry Involvement**

In determining the Revenue Requirement in a manner consistent with the Commission’s commitment to consultation, it will be necessary to establish a process that effectively involves all relevant stakeholders.

Consultation will ensure that all stakeholders, including gas installers and electrical contractors, can provide their views on the appropriate allowances for SSBs.

This will, in turn, increase the chances of establishing the ‘right’ Revenue Requirement and that customers (electrical contractors, gas installer and final customers) do not pay too much for using the regulated services of an SSB.

It is important to consider, at the outset, who is most likely to effectively lead the Revenue Requirement Process. There a number of options for the involvement of the Commission and Stakeholders. Those options vary between light-touch approaches, where the Commission’s role is limited to an oversight and final approval role, and more hands-on approaches involving direct management and control of the process as well as final determination and approval by the Commission. These options can be summarised as:

1. **SSB-led process** - A process determined by the Commission, led by the SSB, including consultation and negotiation with the gas and electrical contracting industries and other stakeholders, with final approval of the outcome by the Commission; or,
2. **Industry-led process** - A process determined by the Commission, led by an industry panel and final determination or approval of the outcome by the Commission; or,
3. **Commission-led process** - A process led and determined by the Commission, including public consultation with the SSBs, the gas and electrical contracting industries and other stakeholders, and final determination of the outcome by the Commission;

The relatively ‘hands-off’ industry-led approach might be considered to have a number of advantages, including inclusiveness and allowing the industry to play a direct role in the regulation of an SSB and allowing the Commission to call on a potentially greater range of technical expertise than it has available in-house. It could also be argued that the need for an SSB to present its plans and the prospect of challenge by a panel of experts may provide greater discipline on costs than behind-closed-doors discussions with the regulator.

The obvious disadvantage of an ‘industry-led’ and “SSB-led” approach is the resource commitment it would require from the industry. However, this would need to be weighed against the less demanding nature of the role of the Commission under such a system. Were such an approach adopted, it would be important to ensure that procedures were in place to ensure fairness and transparency in the actions of the Industry Panel. The Commission also notes that comments from the UK suggest that the experience of using such an approach has been mixed.

Further to the above considerations, and in light of its responsibilities under the Act, the Commission is of the view that it will engage in a “Commission-led process” but, in doing so, it is committed to transparency and consultation in its regulation of SSBs and would provide for an appropriate level of consultation with the industry to feature as part of its Revenue Requirement Process.

#### **4.2.2 Ring-Fencing Arrangements**

Any activities emanating from the designated functions of the SSB will be subject to direct regulation by the Commission, and consequently, shall be subject to the requirements of the economic framework.

It may be the case that a party appointed as an SSB may seek to perform activities which are beyond the scope of the designated functions of the SSB (as specified further to the Act).

Any such additional activities will be required to be undertaken in accordance with any requirements specified by the Commission, without them being subject to “direct regulation” as such.

In considering the approval of any such additional activities, it will be important for the Commission to ensure that the interaction between these and the designated function is well understood. In particular, with respect to the economic regulation of an SSB, it is necessary to ensure that there is no allocation of costs emanating from the additional activities in the Revenue Requirement.

Where any such concerns exist, in order to ensure there is appropriate separation of such costs, there will be a requirement for robust ring-fencing rules and enhanced regulatory reporting requirements.

#### **4.2.3 Revenue Requirement Period**

It will also be necessary to establish the period for which the Revenue Requirement is set.

While an SSB will (subject to satisfactory performance) be appointed for an initial 7 year, and thereafter a 5 year term, it is not necessarily the case that revenues also need to be determined for that period.

There are a number of trade-offs involved in the decision about the appropriate duration of the period for setting revenues.

For example, the longer the period, the lower degree of involvement might be required from the Commission. However, the longer the period, the greater the risk that revenues will be set incorrectly. If this happens, either customers will pay too much or the Commission will be required to revisit the revenue allowance.

In addition, given the relatively sparse information about the costs of an SSB and the fact that costs and demands placed on the SSBs might be expected to be most variable in the early years, forecasting costs over a 7 year period may prove difficult.

There are several possible options:

- *Resetting the Revenue Requirement each year:* This is likely to be resource intensive for both SSB and the Commission, though it might be expected to allow more accurate allowances to be set;
- *A 7 year term:* This is the least intrusive approach (providing it doesn't need to be revisited). However, the uncertainty about costs and volumes might mean that it is also the most risky;
- *3 years then 4 years:* This could be seen as an incremental approach, with the term for which revenues are set building up as more experience of operating the scheme develops. This option could be argued to provide a trade-off between the costs of regulation and the degree of certainty with which allowances could be set; or,
- *Setting a 2-year Revenue Requirement allowance, followed by a 5-year Revenue Requirement allowance:* The initial term of designation will be 7 years, with extensions then being for 5 years. This approach would mean that revenues were set for 5 years, as they will be on an ongoing basis, following a two year period for the scheme to bed-in.

The Commission has not reached a firm view on the period for the Revenue Requirement determination, but considers that providing for an initial two-year period followed by a subsequent five-year period is the most pragmatic and effective approach as it would provide for the period of establishment to be dealt with separately and would allow for better information to be used for the determination of the subsequent five-year Revenue Requirement.

### **4.3 The Revenue Requirement Process**

With the considerations set out in Section 4.2 in mind, the Commission presents its proposed methodology for determining the Revenue Requirement of an SSB:

#### *Fundamentals of the Revenue Requirement Methodology*

- A fundamental output of the economic framework shall be the determination of the Revenue Requirement of the SSB. In determining the Revenue Requirement, the Commission shall be approving the “efficient” costs of the SSB which are to be recovered through the fees/charges of the SSB;
- In order to determine the fees/charges at the outset of the SSB's operations, it is necessary to determine the Revenue Requirement for a fixed period, in advance of that period (“ex-ante”) – i.e. determine the forecast costs of the SSB for the period concerned for undertaking its designated function;
- A key risk in determining the Revenue Requirement, on an ex-ante basis, is that there is a degree of uncertainty associated with the volumes of activity to be undertaken by an SSB across all activity categories over the period for which the Revenue Requirement determination is to apply;
- The volumes of activities to be undertaken will be a key influence in determining what the total outturn costs of the SSB shall be for its operations over the relevant period (as the activities of the SSB are expected to have a high proportion of Variable Costs);

- This is as a result of the total costs of an SSB being a function of the following two distinct cost elements:
  - Fixed Costs of the SSB: the predictable costs of the SSB which do not vary in accordance with the volumes of activity undertaken by the SSB and which include overheads such as premises, IT systems and insurance; and,
  - Variable Costs of the SSB: the costs of the SSB which are directly associated with the activities of the SSB and which vary in accordance with the volumes of those activity undertaken by the SSB. Whilst the “unit” Variable Costs can be determined in advance (i.e. the average cost of undertaking an activity, for example: “the average cost of inspection” or “the average cost of processing an application for Registration”), the total Variable Costs of the SSB cannot be determined in advance, as these shall be a function of the volumes of activity which are ultimately undertaken over the relevant period (and such volumes are, by their nature and at the outset of the new regulatory systems, uncertain).
  
- This would lead to the following challenge with respect the determination of a reasonably accurate Revenue Requirement:
  - the Revenue Requirement would be determined on an ex-ante basis, where the volumes of activity to be undertaken are somewhat uncertain;
  - In this context, determining a set “fixed total pot” for the Revenue Requirement, which is required to cover total forecast costs, may result in significant divergence between the ex-ante Revenue Requirement and the outturn (or “ex-post”) costs of the SSB;
  - this divergence may be as a result of (1) a variation in Fixed Costs and/or (2) the fact that the total Variable Costs of the SSB would have been determined by the volumes of activity undertaken over the relevant period, where these volumes would have been very uncertain at the point at which the ex-ante Revenue Requirement was determined.

*Proposed Methodology*

- It is, however, possible to forecast, with reasonable accuracy, the Fixed Costs of the SSB for the relevant period and also the Variable Costs of the SSB on a “per unit” basis (i.e. the average cost of undertaking a particular activity);
- On this basis, the Revenue Requirement for the relevant period can be forecast by adding the following:
  - the forecast Fixed Costs of the SSB for the relevant period; and,

- the forecast volume of activities for the relevant period multiplied by the “per unit” Variable Costs of undertaking those activities.
- Where outturn volumes of activity do not correspond to the volumes forecast when determining the Revenue Requirement, the entitlement of the SSB to the recovery of any additional Revenue Requirement shall be determined by the variation in volume and not the variation in Unit Costs (as the Unit Costs shall have been “fixed” by the Commission in determining the Revenue Requirement at the outset of the period);
- As the Commission has stated that it will provide for the efficient costs of the SSB to be recovered, the following shall apply:
  - the Commission will have approved the Revenue Requirement of the SSB for the relevant period on an ex-ante basis and on the basis of the consideration of the:
    - Fixed Costs of the SSB;
    - Variable Costs (“per unit” of activity) of the SSB; and,
    - Forecast Volumes of Activity of the SSB.
  - Any divergence between the ex-ante Revenue Requirement (forecast) versus the ex-post Revenue Requirement (outturn) (as determined at the end of the period by the outturn total actual costs of the SSB) can only emanate further to divergence on any of one of the above three components (Fixed Cost, Variable Cost, Volume);
  - Any request for the SSB, then be dealt with in the setting of the Revenue Requirement for the next period (i.e. it would be adjusted up or down accordingly);
- The Commission’s Process for the consideration of any variations on the three components (and any resultant adjustments) is dealt with in Section 6.

On balance and as set out in Section 8, the Commission currently considers that SSBs may be expected to have relatively clearly defined Fixed and Variable Costs (per Unit) and that, as such, the above approach is presented as being the most suitable and effective for determining the Revenue Requirement of the SSB.

**NOTE:** *Appendix 2 presents a number of options for that methodology/process which were considered by the Commission in developing this proposed Revenue Requirement Process.*

#### **4.4 Conclusion**

This section has set out the Commission's views on the process for determining the Revenue Requirement of an SSB which will be required to be recovered through charges.

In the Commission's view, providing a fixed level of revenue to cover Fixed Costs and developing volume drivers to deal with Variable Costs is likely to minimise risk and encourage an SSB to deliver quality services in a timely manner.

It is important that this determination on the Revenue Requirement should be set on the basis of an appropriate period for its duration in order to balance the considerations of accuracy and effort.

The Commission also considers that, by setting sensible rules about how any cost savings and cost overruns will be treated, it will be possible to encourage an SSB to seek to minimise costs without compromising service quality. These matters are further discussed in Section 6, which examines the Review and Adjustments Processes further to the performance of the SSB over the Revenue Requirement period.

The Commission's proposed Revenue Requirement Process is presented in Section 7 of this paper, in the context of the overall framework for the economic regulation of SSBs.

## **5 Charges Approval Process**

### **5.1 Section Overview**

The Act states that the Commission shall approve the fees/charges of an SSB. Furthermore, the Commission has stated, further to the provisions of the Act, that fees/charges are to support the operation of the new regulatory systems such that they allow for the objective of being economically robust and self-financing to be achieved.

On this basis, and having determined the level of Revenue Requirement (which tells us the level of revenue which is required by the SSB in order to meet its anticipated costs), it is necessary to determine how the fees/charges for the SSB for the provision of services are to be approved by the Commission.

Such fees/charges would be applied by the SSB to the activities to be undertaken by it further to its designation functions, where such activities involve the provision of services to customers of the SSB. In this instance, “customers” means parties registered with it or any such other parties engaging the services of the SSB. Such services may include, among other things:

*For parties registered with the SSB (Registered Electrical Contractors or Registered Gas Installers, as the case may be):*

- Fee for the application for Registration;
- Annual Registration Fee (renewal fee); and,
- Purchase of Completion Certificates.

*For other parties (primarily other industry parties and/or final customers):*

- Direct Inspection fees<sup>4</sup>;
- Purchase of Copies of Completion Certificates previously issued.

This section of the paper examines the options with respect to the methodology for determining the charges to be applied by an SSB (its Charges Approval Process).

### **5.2 Options for the Charges Approval Process**

The Commission has identified a number of options for the process in approving the charges of the SSB. This is a critical process in the economic framework as it will:

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<sup>4</sup> In the instance of an SSB designated as an Electrical Safety Supervisory Body, and as specified in the Act, the SSB will be required to inspect electrical installations carried out by non-registered electrical contractors (“Third Party Inspections”). Further details in this are presented in the Commission’s Vision and Criteria Documents for the new electrical safety regulatory system as referred to in Appendix 1 of this Consultation Paper. The Act also provides for a person on whose behalf a registered gas installer has carried out any gas works may request that the Gas Safety Supervisory Body carry out an inspection of those works.

- be a key influence in determining the ability of the SSB to recover its Revenue Requirement; and,
- determine the costs faced by users of the regulated services of an SSB, in this case gas installers, electrical contractors and the public and, given that gas and electrical works are to be regulated, will determine the costs of safety regulation which are to be faced by the public.

The options are now discussed below.

### **5.2.1 Option 1 - Industry-led Approach**

One approach to setting charges involves an independent expert panel being established which would advise on the setting of charges.

For example, the Industry Panel (appointed by the Commission) would consider and challenge proposals brought forward by each SSB, with the Commission ultimately approving a charging methodology based on the recommendations of both the Industry Panel and the SSB.

This approach might be expected to build the scheme's credibility by including a range of stakeholders. However, it may take a significant resource commitment and establishing a suitably representative Industry Panel and ensuring fairness, with an absence of self-interest, might prove difficult.

The Commission is of the view that this approach on its own would not be appropriate for the purposes of determining the fees/charges of an SSB. However, the Commission is committed to transparency and consultation in its regulation of SSBs (further to the principles of the economic framework) and would provide for an appropriate level of consultation with the industry to feature as part of its methodology for approving the fees and charges of an SSB.

### **5.2.2 Option 2 – Determination of Charges by the Commission**

The most prescriptive method of charge-setting would be for the Commission to directly set the fees and charges for the various services associated with the designated functions of the SSB.

Having decided on the Revenue Requirement, the Commission would also be required to design an appropriate charges/fees structure for recovering that revenue.

This approach might be expected to give the Commission the most control over the charges faced by parties using the services of an SSB (the gas installer industry, the electrical contractor industry and customers of either industries, as the case may be). However, this would require a significant resource commitment and, in practice, might not be dissimilar from the first option given that the Commission might need to call on external expertise.

### **5.2.3 Option 3 - Agreed Principles Approach**

The third option which, on balance, the Commission considers is likely to be most appropriate, would be to develop a high-level set of principles which an

SSB would be required to comply with. The SSB would then be required to develop a series of charges based on these principles, with the Commission required to periodically approve the approach, following consultation, to ensure it is consistent with the objectives.

The Commission's initial views on these "Charging Principles" are set out below:

- **Cost reflectivity** - If fees/charges are reflective of the costs of providing an activity, an efficient signal will be sent to users of the service whilst ensuring fairness and non-discrimination;
- **Stability** - It is also important that the users of a service can predict the path of charges so that they can factor them into business planning. Stability is a difficult issue and can occasionally contradict with cost-reflectivity;
- **Transparency** - The Commission recognises that gas installers and electrical contractors are likely to be key stakeholders with respect to the process for the determination/approval of charges. In light of that, it is important that these charges are determined/approved in an appropriately transparent manner. The Commission would expect to consult extensively on the determination of the appropriate Revenue Requirement for an SSB and on the proposed approach of an SSB to its setting of charges. The Commission would expect to make sure that comments had been fully considered in deciding on whether to approve any methodology put to it by an SSB.

In practice, the following high-level approach to the approval of charges would be followed by the Commission:

- the SSB will be required to submit to the Commission for approval its proposals for charges and demonstrate the basis for these (which are to be in line with the Charging Principles);
- as part of this process, the Commission shall require that any proposals by the SSB are published for public and industry consultation and the Commission shall, in its consideration of the proposals of the SSB, take account of any such representations further to that consultation process.

In the Commission's view, the above will aid transparency and allow the industry and public to understand how the charging framework operates.

### **5.3 *Format of Charging Methodologies***

The Commission will take a view on the appropriate trade-off between objectives when it comes to approving the charging methodologies which the SSB will be required to develop.

The Commission does not envisage that these would need to be hugely complex or technical documents, but considers that there is merit in each party setting out how it goes about calculating charges and confirming the extent to which

this is consistent with the approved principles established further to the Commission's requirements. In the Commission's view, this will aid transparency and allow the industry and public to understand how the charging framework operates.

## **5.4 Conclusion**

In the Commission's view, the options for charge setting are limited and consider that, on balance, setting out a series of principles and asking an SSB to develop statements which set out how they will calculate charges consistent with these principles represents the most appropriate option.

While the Commission has not reached a firm view on the appropriate principles, cost-reflectivity, stability and transparency are important principles upon the basis of which any charging methodology should be applied. The Commission also acknowledges the need for extensive stakeholder consultation in deciding on the approach to charge setting.

The Commission's proposed Charging Approval Process is presented in Section 7 of this paper in the context of the overall economic framework.

## 6 Review and Adjustment Processes

### 6.1 Section Overview

The previous two sections of the document have broadly set out the actions which the Commission would need to undertake prior to an SSB beginning to perform its role – i.e. the determination and approval of the Revenue Requirement and the Charges to be applied in order to provide for the recovery of that Revenue Requirement. The approval of these is based on forecasts (ex-ante). Clearly, with the operation of the SSB, it is likely that the outcomes in terms of:

- volumes of activity;
- outturn costs; and,
- outturn revenues

will be different from these forecasts provided at the outset of the Revenue Requirement period and upon which basis the Commission’s approval of the Revenue Requirement and Charges was granted.

Hence, in order to ensure that the economic framework delivers upon its objectives, and in particular that the **efficient costs** of the SSB may be covered through the revenues obtained by the SSB, it is necessary to carry out a “Review and Adjustment Process” in order to take account of the outturn volumes, costs and revenues.

This Section presents the measures/steps required within that Review and Adjustment Process in order to deal with the above questions and how those measures may need to be applied at the end of each year and at the end of each regulatory period to allow for the inputs into the economic framework to be updated or recalculated as a result of the outputs from the economic operations of the SSB.

### 6.2 Review and Adjustment Process - Overview

This Review and Adjustment Process will entail the following key stages/features:

- Reporting by the SSB to the Commission on its activities (operational and financial/economic reporting) and the Commission’s consideration of same (“Review”);
- Further to the “Review” activities:
  - periodic Adjustments to Revenue Requirement/Charges (“Adjustment”) (Section 6.2.1); and,
  - Enforcement Actions by the Commission with respect to the performance of the SSB with respect to its designated function (which

shall include consideration of both the operational and economic issues) (“Enforcement”) (Section 6.2.2).

Each of the above is now discussed.

### **6.2.1 Review**

The Commission will be specifying a series of outputs at the start of any period for which the Revenue Requirement is to be set.

Outputs, in this context shall relate to the performance requirements for the SSB in undertaking its designated function. Such requirements shall relate to Operational and Economic aspects of the SSB’s performance, and shall be specified through the means set out below.

#### *Operational Requirements*

The overarching consideration in terms of operational outputs shall be the delivery, on the part of the SSB, upon its obligations with respect to safety with regard to its designated functions. These shall be judged through reporting (supported by audit and inspection by the Commission) on the SSB’s performance with respect to the requirements specified further to:

- the Terms and Conditions of Appointment;
- the provisions of the Criteria Document (for example, the approved Annual Audit and Inspection Programme of the SSB);
- its proposals as part of the Designation Process (to the extent that these are binding); and,
- any other relevant requirements (pursuant to the Act, other legislation or directions issued by the Commission).

#### *Economic Requirements*

Further to the “Operational Requirements”, the requirements with regard to the SSB’s financial/economic performance shall be specified further to the Commission’s Revenue Requirement and Charges Approval Processes.

The above will provide clarity about the obligations that the SSB would be expected to meet in return for the Revenue Requirement.

In order to monitor an SSB’s operational and economic performance, the Commission will require data on their performance relative to the package of outputs specified by the Commission. The Commission initially expects to collect this data on a quarterly and annual basis.

Reporting requirements will be developed in detail in subsequent documents (namely, under the Criteria Document and in the Terms and Conditions of Appointment). These might be expected to include the following:

- the outturn level of spending on Fixed Costs relative to the allowance set by the Commission, including details of activities undertaken;
- the actual costs of providing individual activities relative to the Unit Costs approved by the Commission;
- the number of each type of activity/service provided;
- any circumstances that the SSB considers to be exceptional; and,
- depending on the past performance of the SSB and the method of dealing with cost savings or overruns, any discretionary spending or increased remuneration for staff or any activities undertaken to remedy poor performance.

This Reporting would inform the Commission on its determination on any adjustments to the Revenue Requirement or the Charges approved. This is discussed below.

### **6.2.2 Periodic Adjustments to Revenue Requirement/Charges**

Further to the reporting on the economic performance of SSB, the Commission will periodically need to conduct a review of the efficiency of an SSB's spending.

The Commission recognises that, in order to ensure that an SSB is operating efficiently, there is a need for some sort of post-performance (ex-post) assessment by the Commission. This assessment would determine how well the SSB has performed and identify the sources of any deviations between forecast and outturn costs.

The purpose of this review in the context of the economic framework will be to establish to what extent the SSB has deviated from the forecasts provided at the outset of the Revenue Requirement and Charges Approvals processes. It is important that any outturn deviations are understood and therefore their treatment in the context of the economic framework can be determined.

Depending on the outcome of this review, a change to the Revenue Requirement might need to be made and, consequently, charges for the next period adjusted accordingly. In implementing new economic framework, the Commission shall issue guidance to the SSB on how it would treat requests for the provision for an additional Revenue Requirement in order to cover unforeseen costs.

This review process would be likely to determine:

- **The deviation between outturn and forecast volumes** - The proposed approach to the Revenue Requirement Process (as presented in Section 4) will determine how much extra revenue is needed to cover differences between the forecast and actual amounts of activity.
- **Whether an exceptional event had occurred leading to any such deviations identified**- The Commission would expect to assess any evidence presented by the SSB about an exceptional event against the criteria it had set out. If required, it would take a view on whether revenue going forward needed to be adjusted to cover unforeseen costs;

- **An adjustment for cost savings/cost overruns** - The assessment of efficiency could reveal either a cost saving or a cost overrun which will need to be treated in accordance with the framework chosen by the Commission for dealing with such events and which may lead to a change in revenues (this is discussed below).

This review would lead to an assessment of the amount by which revenues would need to change (a revised Revenue Requirement is determined and approved by the Commission) and, possibly, a corresponding change in charges (entailing the approval, by the Commission, of Revised Charges). The considerations concerning that determination are discussed below.

While it acknowledges that there may be circumstances where increases in cost may be beyond an SSB’s control, the Commission is of the view that, in so far as is possible, the Revenue Requirement set at the start of a period should not be revisited during that period.

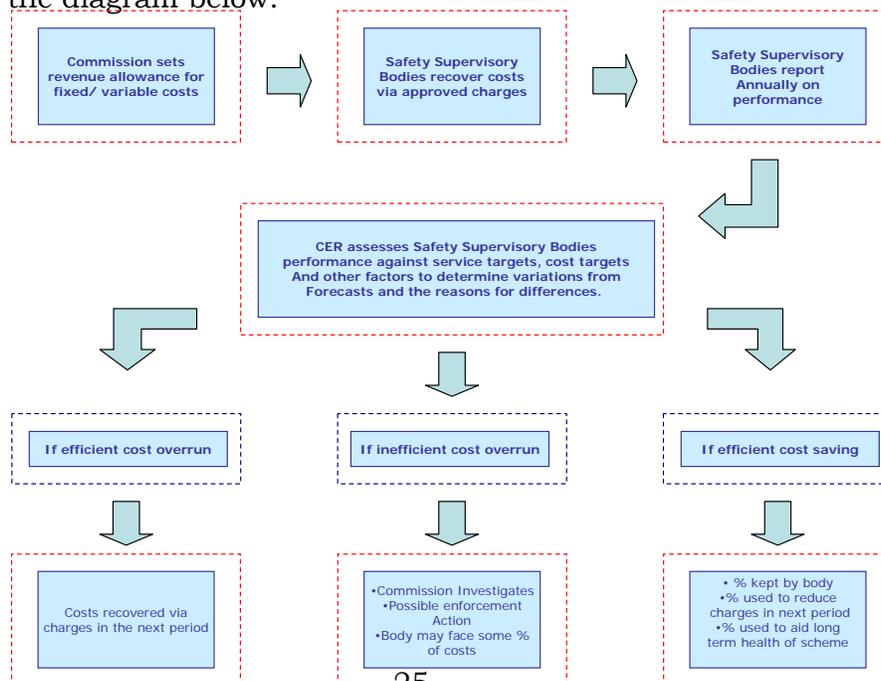
The Commission would expect to require that a strong case, backed by robust evidence, was made before it could consider revisiting its determinations on the Revenue Requirement.

**Treatment of Deviations**

As stated above, it is very likely that each SSB’s outturn costs will be above or below the level forecast at the outset of the regulatory period, when the Revenue Requirement was being determined.

Given that an SSB will be operating on a not-for-profit basis, this raises the question of how **cost overruns** or **cost savings** should be treated.

Having established whether a cost saving or cost overrun is driven by efficiency or inefficiency (through the “Review” process described above), the Commission needs to take a view on how the resultant situation should be treated. This is shown in the diagram below.



The Commission's views on the treatment of each of these scenarios is presented below:

### **Cost Overruns**

A cost overrun could indicate that:

- the Revenue Requirement at the start of the period was incorrectly set (i.e. the allowance was overly low and no efficient operator could have been expected to cover costs); or,
- an event, which could not have been reasonably foreseen at the time when the Revenue Requirement was set, took place; or,
- the SSB was unable to perform its functions efficiently and economically.

The approach to the treatment of cost overruns will depend on the financial obligations which the Commission determines SSB should face.

It is the Commission's view that it is required to fund **only** the efficient costs of an SSB and this will influence its approach to the treatment of any cost overruns.

The alternative to this would be to provide for the Commission to make up **any** shortfall of funds (including or excluding the costs of funding the shortfall) – this would not be in the interests of the industry or the customers of an SSB.

Hence, limiting the entitlement of recovery of cost overruns that are considered efficient would increase risk and may reduce the number of parties which were keen to participate in the Designation Process.

If an ex-post assessment determines that the cost overrun resulted from inefficiency by an SSB, a number of options are available:

- On the one hand the Commission might take the view that this was indicative of the SSB's inability to carry out its role and may choose to de-designate it (see Section 6.3 ahead (Enforcement));
- it could alternatively provide no revenue allowance to cover the shortfall, meaning that the SSB would be responsible for the overrun (either in full or in part).

### **Cost Savings**

A cost saving relative to allowances could indicate that the Revenue Requirement was incorrectly set or that the SSB had performed efficiently and made cost savings.

If an ex-post assessment determines that a cost saving has been achieved as a result of good performance by an SSB, a decision needs to be taken about how those saved costs should be used. Again there are a range of options:

- Firstly, the costs could be used to reduce charges in the next regulatory period. In this case, the full benefits are returned to parties registered with the SSB (though not necessarily the same parties) in subsequent periods.

However, it is not clear that it would provide an SSB with a particularly strong incentive to strive to reduce costs and outperform Unit Costs or efficiently under-spend Fixed Cost allowance set by the Commission.

- Alternatively, the cost saving could be retained by the SSB. The most extreme version of the option would allow cost savings to be spent on anything an SSB saw fit, including remuneration (and indeed it might be desirable for an SSB to specify a series of targets at which managers received certain bonuses to further incentivize good performance). This would give a strong incentive for the SSB to manage its costs and efficiency, whilst performing to the standard required (further to the Commission's specification of its requirements in that regard, as discussed in Section 6.2.1).
- An alternative approach to the above might be to specify guidelines about the type of activities that cost savings could be reinvested in. This might include discretionary activities which would benefit the scheme as a whole. One variant of this approach might see cost-savings paid into some sort of fund which could then be used to offset any future efficient cost-overruns and might reduce the requirement for an SSB to hold financial securities.

The options above could be combined to try and develop a package that shared benefits between the SSB and the new regulatory system, and thus retained performance incentives through reduced ongoing costs.

For example, were the Commission to specify in advance that a certain percentage of any cost saving could be retained by an SSB for spending on discretionary activities, a percentage could be used to offset revenues in the next period and a percentage would be paid into a fund to enhance the long term operation of the scheme, it would appear that the incentives of any SSBs, registered parties, the public and the Commission might be aligned.

### **6.3 Enforcement**

Further to the basic processes of Review and Adjustment as described above, the Commission considers that the overall economic framework will be complemented by enforcement measures designed to promote certain behaviours by SSBs.

Where the performance of the SSB deviates below the standard/level required and specified by the Commission (as set out in Section 6.2.1), it is critical that swift action is taken to address any instances of poor performance. Poor performance has the potential to undermine the objective of public safety and undermine consumer confidence in the scheme, dent the brand images developed by the Commission and potentially lead to users of the services of an SSB paying too much for the scheme.

There are a range of options available to the Commission in dealing with poor performance against the specified outputs. These include the following:

- The most extreme option would involve removing an SSB's designated status. However, de-designating is unlikely to be a proportionate option in all cases and would only appear practical if there had been a prolonged period of non-compliance. It might therefore be appropriate to set out a series of measures to address the poor performance of an SSB<sup>5</sup>;
- Furthermore, the Commission may consider whether there may be a need to increase the reporting requirements facing poorly performing SSBs or whether the management of that SSB should be required to justify the factors behind the poor performance and suggest remedies at an oral hearing in front of the Commission;
- The Commission would also consider whether there might be a role for the industry in assessing the extent to which each SSB was complying with required standards given its ability to call on a significant amount of sector specific knowledge and experience. It might also be appropriate for a poorly performing SSB to explain to the Commission and the industry the factors underlying its poor performance.

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<sup>5</sup> The Commission shall give consideration to imposing requirements concerning financial bonds which must be put in place by an SSB and which would relate to, among other things, the performance of an SSB.

# 7 The Commission's Proposed Economic Framework

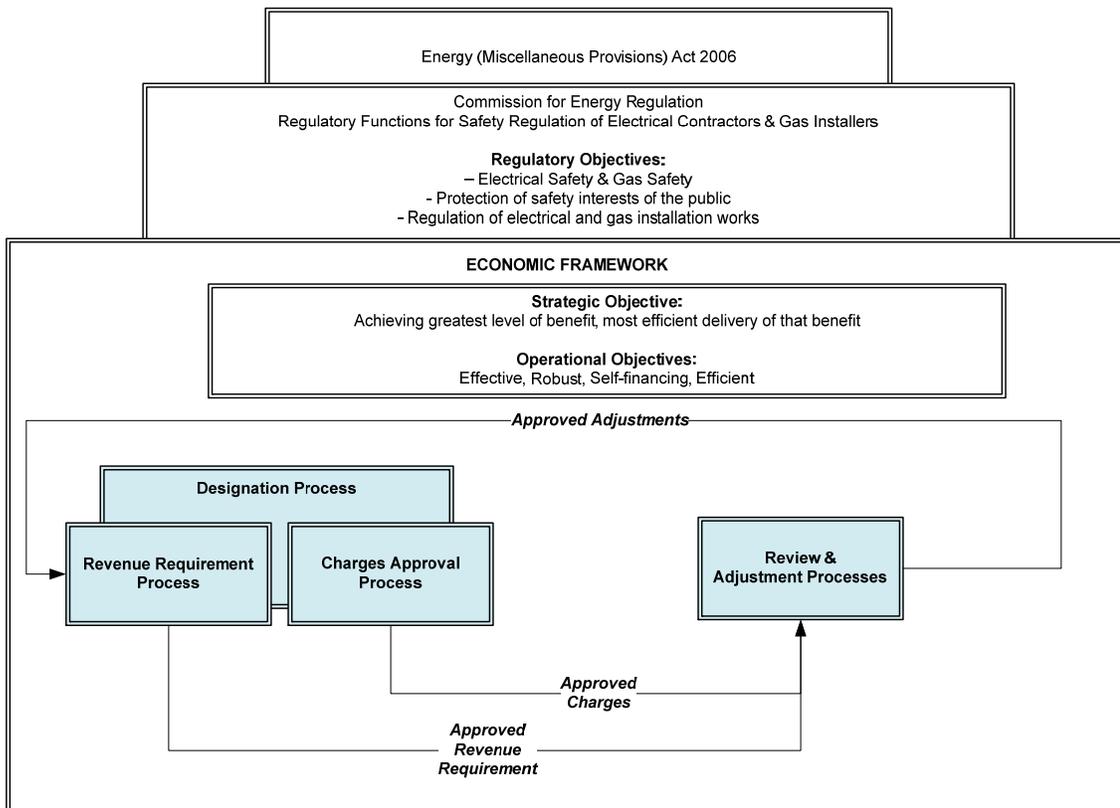
## 7.1 Section Overview

This Section combines the Commission's proposals as set out in previous sections for the economic framework as a whole. In doing so, the Commission presents its preferred overall approach, which constitutes the economic framework on which the Commission now invites comment.

The Commission has sought to provide as much detail as possible at this stage in order to enable interested parties to understand and comment on the Commission's proposed approach. However, the Commission recognises that some details of the approach will need to be developed further and welcomes respondents' views on areas upon which they may require further clarity.

## 7.2 Operation of the Proposed Economic Framework

The Commission presented its overview of the proposed economic framework in Section 3. This is illustrated below.



Further to this high-level approach, and the Commission's proposed Objectives and Principles (as presented in Section 3), the Commission now presents its

proposed operation of each of the three key elements of the economic framework identified:

- the Revenue Requirement Process (Section 7.2.1);
- the Charges Approval Process (Section 7.2.2); and,
- the Review and Adjustment Processes (including the proposed treatment of deviations) (Section 7.2.3).

These are now discussed in turn below.

### **7.2.1 The Revenue Requirement Process**

The first issue which the Commission must address in determining the Revenue Requirement is the period for which they will be set. The Commission's initial view is that a two-year period followed by a five-year period (subject to the Terms and Conditions of Appointment) represents a pragmatic and incremental approach.

The Commission further considers that this approach reflects the initial difficulty in setting accurate revenues, as discussed in Section 4.

The Commission considers that providing an approved Revenue Requirement to cover Fixed Costs and developing a Unit Cost allowance to cover Variable Costs would combine to produce the most appropriate system of revenue regulation. This hybrid approach would see the Commission assessing what constitutes an efficient level of Fixed Costs and the cost at which individual activities should be able to be performed.

The proposed process would operate as follows:

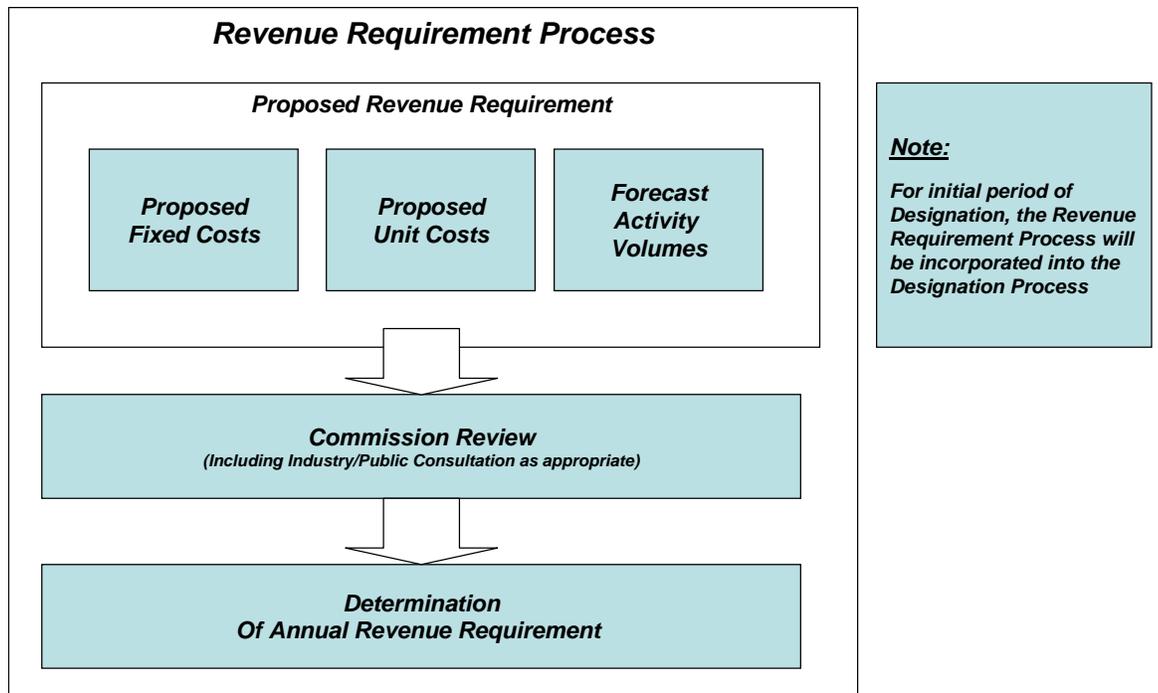
1. As part of the **Designation Process**, an SSB would be required to put forward forecasts of:
  - a. the total Fixed Costs, to cover activities such as premises, marketing and overheads; and,
  - b. the Variable Costs (on a fixed Unit Cost basis) for each of the categories of activity the SSB would be required to undertake (for example, the Unit Cost for undertaking an inspection).

Furthermore, to determine the total amount of revenue that should be provided to recover costs (i.e. the Revenue Requirement), the SSB would also be required to develop a forecast of the level of activity which it would be expected to undertake in each category;

2. In each year, the Revenue Requirement would be based on the allowance for Fixed Costs in that period, plus an average revenue per unit allowance to cover Variable Costs. This would be accompanied by a volume trigger that amends the variable element in the event that demand fell below a certain level;

3. In addition, the Commission considers that it may be appropriate to include an allowance for efficiency improvements in the allowance for Fixed Costs. It seems reasonable to expect that performance will improve and that customers and the industry should receive these benefits;
4. Out of the above, a forecast of total Revenue Requirement would be set for each year of the regulatory period (e.g. each of the two years in the first instance) – i.e. the annual Revenue Requirement for each year of the review period.
5. Further to the above, the Commission would publish its determination on the Revenue Requirement.

Below, the Commission presents a diagram illustrating the above process.



**Note:**  
For initial period of Designation, the Revenue Requirement Process will be incorporated into the Designation Process

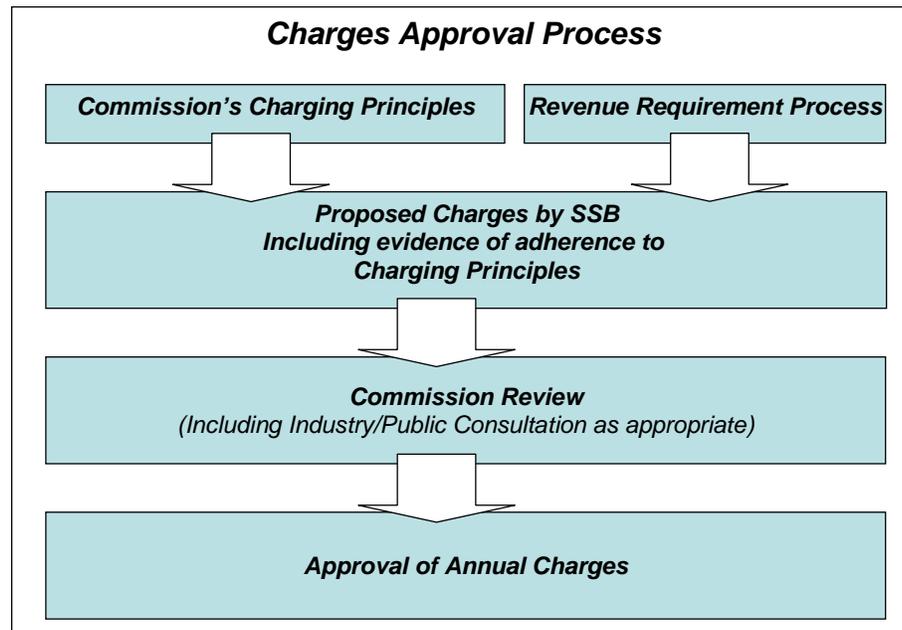
## 7.2.2 Approval of Charges

Further to the determination on the Revenue Requirement, the SSB would require Commission approval on its fees/charges for the provision of its services to gas installers, electrical contractors and the public (as the case may be).

The Commission is of the view that it shall approve charges in the following manner:

1. The Commission shall specify the Charging Principles as presented in Section 5;
2. An SSB, in presenting its proposed charges, must demonstrate that its proposed charges are determined in accordance with the Charging Principles;
3. In presenting its proposed charges, the SSB shall present actual proposed charges for the first year and forecast charges for subsequent years;
4. Broadly speaking, it would be expected that the charge for the services provided by the SSB would be based on the Unit Cost of providing the service, plus a proportion of Fixed Costs (which in turn would be based on the forecast volume of activity);
5. It shall be a requirement that the SSB's proposed charges are published for consultation;
6. Further to that consultation process and the Commission's consideration of the SSB's proposals, the Commission shall make a determination on its approval of these charges.

Below, the Commission presents a diagram illustrating the above process.



### 7.2.3 Review and Adjustment

At the end of each year of the review period, there would be need for a limited review by the Commission. The Commission would need to:

1. consult on and review information provided by SSBs to determine the efficiency of spending against the specified outputs;
2. consider whether there were any exceptional events;
3. consider the deviation between forecast volumes and actual volumes;
4. determine the treatment of any such deviations; and,
5. make the necessary adjustments for “approved” deviations.

The methodology for dealing with the above is set out below.

1. *Determination on the efficiency of spending:*

The Commission would review information on performance and the use of funds to determine whether the SSB had operated efficiently.

This would be likely to involve considering whether the desired package of outputs had been delivered at lower than the set Unit Cost (for example, assuming that the Unit Cost of registering a party was set at €100 (and that target was correct), if the service had been delivered for an average cost of €90, an efficiency saving of €10 would have resulted).

2. *Determination on Exceptional Events:*

The Commission would assess any evidence presented by the SSB about an exceptional event against its specified criteria. If required, it would take a view on whether revenue going forward needed to be adjusted to cover unforeseen costs.

3. *Adjusting for Deviations:*

The assessment of efficiency could reveal either a cost saving or a cost overrun.

If there is a cost-saving, a proportion will be retained by the SSB and a proportion will be retained for the future. The remainder will be used to reduce charges. The Commission will need to ensure the Revenue Requirement for the next period (or periods) would be adjusted accordingly.

For example, where an SSB had a cost overrun but could prove that the overrun was necessary in order to deliver the required package of outputs efficiently, there would be cause to *inflate* the Revenue Requirement going forward to reflect these costs. Where the overrun was inefficient, there may not be cause to make an adjustment to the Revenue Requirement.

4. *The deviation between outturn and forecasts:*

The volume driver mechanism will determine how much extra revenue is needed to cover differences between the forecast and actual amounts of activity. This will be done for each activity, resulting in a net increase or decrease in the level of revenue.

To illustrate: for each activity, the Commission would calculate:

- a. the forecast volume multiplied by the forecast Unit Cost; and
- b. the outturn volume multiplied the forecast Unit Cost.

Subtracting (a) from (b) above would give a positive or negative number. When this was done for each activity, a net adjustment would result.

5. *Adjusting the level of revenue:*

At the end of the period, the following adjustments would therefore be made to the Revenue Requirement for the next period.

- An adjustment made for exceptional events (increase);
- An adjustment made for cost savings (decrease – as determined by the Commission and discussed in Section 6);
- Potentially an adjustment made for cost overruns (increase or decrease);
- An adjustment made for volume changes (increase or decrease).

This new Revenue Requirement derived from the above would be used to determine charges for the subsequent period (with such determination being in line with the Charging Principles as approved by the Commission).

The Commission realises that this approach means that charges can be variable from year to year, depending on the accuracy of forecasts.

It also notes that relatively little notice of actual charges can be provided. It considers this is necessary to ensure that costs are efficient. However, it is considering what information on performance it would require to allow indicative tariffs to be set with greater notice and whether the SSBs should have an obligation to produce these forecasts.

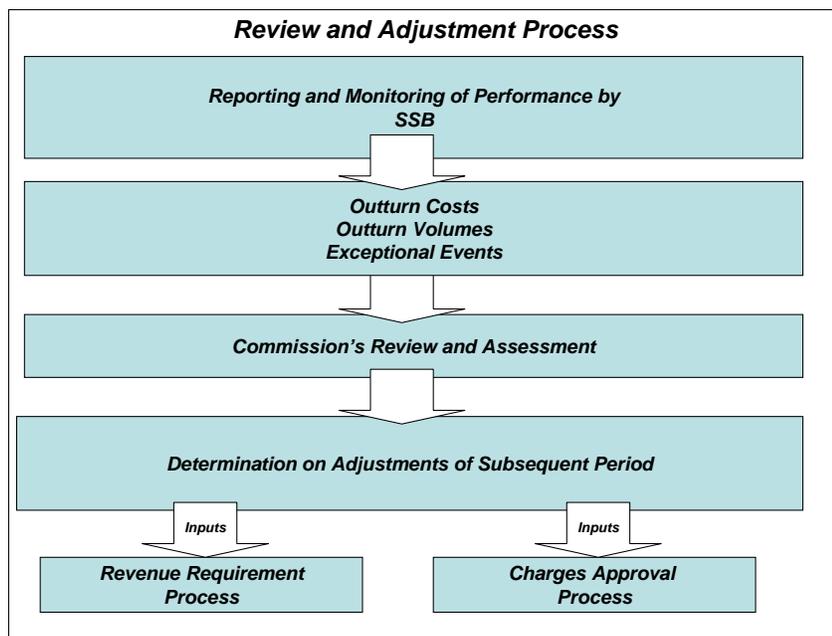
At the end of the regulatory period, the Commission would expect to go through the same steps as it would be required to do at the end of each period. In the case of the first period, which the Commission proposes to break into a two year and a five year period for which the Revenue Requirement is set, the Revenue Requirement for the five-year period would need to be determined via consultation, discussion and scrutiny of performance to date; as the Commission would be unable to draw on information generated via a tender process.

In future periods (and in the first instance towards the end of the 7 year term), the Commission would expect to carry out a more thorough assessment of

performance, including learning any lessons for the regulatory framework from performance during the period, as the period drew to a close. Based on this information, it would consider updating elements of the approach, following consultation.

At the end of the period, it would also begin the process of re-appointing SSBs. Assuming there was sufficient competition, it would again expect to run a tender process and to base its assessment of the Revenue Requirement on information generated via that process, in addition to information generated in previous periods, consultation and negotiation.

Below, the Commission presents a diagram illustrating the above process.



### **7.3 Assessment of the Proposed Economic Framework**

In the Commission's view, the approach outlined in this section represents a proportionate approach to regulating the new electricity and gas safety regulatory systems.

While the approach may appear relatively complex, the Commission does not consider that it would impose unnecessary additional costs on the industry and considers that the measures proposed shall give rise to greater cost savings over time than would otherwise be the case.

However, the Commission will frequently monitor the effectiveness of the regulatory approach and make changes to improve its operation where required.

In Section 3, the Commission presented its objectives and principles for the economic framework in the context of the Regulatory Objectives. The Commission is of the view that its proposals set out in this paper shall provide for:

- the achievement of the Regulatory Objective of the new regulatory systems with respect to safety and the specified performance requirements of an SSB;
- and, in doing so, shall deliver the maximum safety benefit at the minimum cost.

The above will be achieved through the proposed economic framework which seeks to ensure that economic performance of an SSB is regulated and reviewed in order to ensure that it delivers on **the effective operation of the SSB at an efficient level of costs** and, in doing so, provides for the **SSB's operation to be economically robust and self-financing**.

### **7.4 Consultation**

The Commission now invites comments on the proposals as set out in this Consultation Paper.

In particular, the Commission invites comment on its proposals with respect to:

1. the objectives and principles for the economic framework, as presented in Section 3; and,
2. the Revenue Requirement Process, the Charges Approval Process and the Review and Adjustment Processes, both in terms of the specific aspects of the operation of each, and the interaction of each of these in the context of the overall economic framework as presented in this Section 7.

Comments should be presented in accordance with the requirements specified in Section 1.3.

## Appendix 1: Background and Further Information

On December 24<sup>th</sup> 2006, the Energy (Miscellaneous Provisions) Act 2006 (“the Act”) was signed into law.

Section 4 of the Act provides the Commission with the statutory authority to “*regulate the activities of electrical contractors with respect to safety*”. The Act specifies the functions of the Commission associated with this authority<sup>6</sup>.

Furthermore, Section 13 of the Act provides the Commission with the equivalent function with respect to the regulation of the activities of gas installers with respect to safety.

In addition to granting the above functions, the relevant sections of the Act also specify certain requirements with respect to the design and implementation of the new regulatory systems associated with those functions.

The Commission has set about a three-stage process for the design and implementation of each of the new regulatory systems, constituting:

- the design of the high-level regulatory framework through the presentation of the Commission’s “**Vision**” for each of the new regulatory systems;
- the detailed rules for the operation through the development of the **Criteria Document** for each of the new regulatory systems; and,
- the design and operation of the process for the designation of parties as SSB within either new regulatory system (“the **Designation Process**”);

Further to the above, the Commission has published the following documentation:

- *Electricity:*
  - Vision for the Regulation of Electrical Contractors with respect to Safety (reference: CER/07/203 and CER/07/204);
  - Consultation on the Proposed Criteria Document for the Regulation of Electrical Contractors (reference: CER/07/213-1/2/3/4/5);
- *Gas*
  - Vision for the Regulation of Gas Installers with respect to Safety (reference: CER/07/225 and CER/07/221).

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<sup>6</sup> A full transcript of the relevant provisions of legislation is provided in Appendix A

## **Appendix 2: Discussion on Options for the Revenue Requirement Methodology**

Section 4 of this document presented the Commission's proposal for the methodology of determining the Revenue Requirement.

This Appendix sets out some of the generic methodologies which the Commission considered in its development of the proposed Revenue Requirement methodology. These are being presented by means of background to the Commission's proposal.

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### **Option 1 - Regulation of Individual Charges**

This would be a relatively prescriptive option involving the determination of charges for individual activities according to efficient activity-based cost estimates. Activity-based costs would be likely to incorporate an estimate of the marginal cost of carrying out a unit of a particular activity and adding on an appropriate allocation of fixed and common costs.

The revenue requirement is, under this approach, determined at the level of an individual unit of activity. For that reason, SSB total revenues would rise or fall in line with output, which results in a healthy incentive not to restrict output. However, if demand is significantly lower than projected, total revenues could end up being insufficient to recover fixed costs.

To protect against this, it may be necessary to introduce a factor that adjusts prices in future years to a level that permits full recovery of fixed costs. This might, in turn, lead to undesirable tariff volatility.

The advantage of this approach lies in potentially greater confidence in the cost-reflectivity of charges and in the elimination of cross-subsidisation. A disadvantage is the loss of discretion for the SSB in determining individual charges. Such discretion may or may not be desirable, depending on the certainty that can be attached to activity-based costings in the early stages of the scheme.

The approach could also be expected to involve lengthy negotiations and potentially greater regulatory costs arising from its prescriptive nature. However, it would, unlike in Options 2 and 3 below, obviate the need for a separate process to determine individual charges.

## **Option 2 - Regulation of Average Revenues**

The first step under this approach would be to define a unit of output. This might be the aggregate of a number of activities or a single main activity for which all other activities are ancillary and/or complementary. Once, demand and total costs are projected, the latter is simply divided by the former to determine a revenue requirement at the level of average revenues across all activities. This is a slightly less prescriptive option, except in when the SSB is (as it may be) deemed to have a single product/activity, in which case it is equivalent to Option 1 above.

This approach, unlike Option 1 above, has the advantage (where there are multiple activities) of leaving discretion with the SSB to determine individual charges, which might be desirable if there is likely to be a high degree of uncertainty associated with activity-based costings during the early stages of the scheme. It is also likely to be less onerous in terms of the regulatory burden on the Commission. Its disadvantage might be a greater risk of losing cost-reflectivity in individual charges and of cross-subsidisation. However, this would be monitored through the process for setting individual charges that would come after determining the average revenue requirement.

The revenue requirement is, under this approach, determined at the level of the average per unit of output. For that reason, SSB total revenues would rise or fall in line with output, which again results in a healthy incentive not to restrict output. However, if demand is significantly lower than projected, total revenues could end up being insufficient to recover fixed costs. As under Option 1, it may be necessary to introduce a factor that adjusts allowed or maximum average revenues in future years to a level that permits full recovery of fixed costs. This might, in turn, lead to undesirable tariff volatility.

## **Option 3 - Regulation of Total Revenues**

This involves the projection of an SSB's total costs of providing a given level of projected demand. A revenue requirement is then determined at the level of total revenues across all activities. This is again a slightly less prescriptive approach compared with regulating individual charges and is similar to the approach of the Commission in regulating network companies.

The approach has the advantage of leaving discretion with the SSB to determine individual charges for its activities. Also, the approach might be expected to lead to an efficient revenue allowance if unexpected cost overruns in one category were matched by unexpected cost savings in others.

Option 3 offers greater certainty than 1 or 2 in the face of deviations from forecasted demand. However, the incentive not to restrict output that exists under Options 1 and 2 does not exist under this Option because, in order for total revenue not to exceed the requirement when demand is higher than projected, prices would have to fall.

## **Option 4 – A Hybrid of Average and Total Revenue Regulation**

Another option is to seek to reflect the factors that drive the costs of the business. When the majority of costs are variable, the optimal solution would be to regulate average revenues (Option 2) or individual charges (Option 1). Where the majority of costs are fixed, the optimal solution would be to regulate total revenues (Option 3 above).

However, it is possible to retain the attractive features of a combinatory Option 2 and Option 3 approach in a manner that is proportionate with the fixed-variable split in the SSBs' cost structure. The revenue requirement could consist of a fixed element, a variable element and a volume trigger that, if demand falls below a certain level such that the totality of the fixed element could not be recovered, the variable element would be increased.

On balance and as set out in Section 8, the Commission currently considers that SSBs may be expected to have relatively clearly defined fixed and variable costs and that, as such, a hybrid of average and total revenue regulation might be most effective.

***The Commission has presented this Option 5 as its proposed methodology for determining the Revenue Requirement (the Revenue Requirement Process) in Section 4.***