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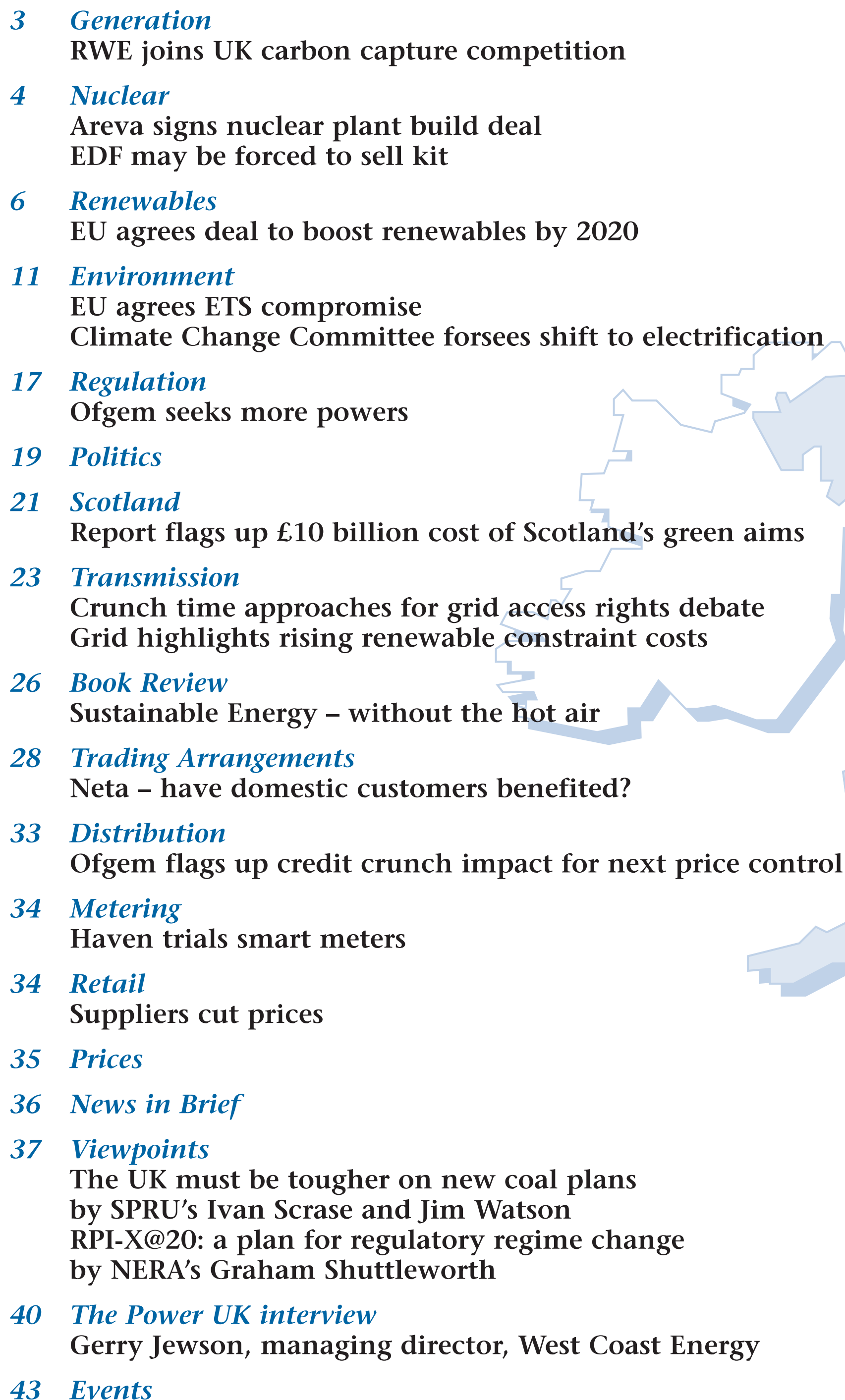
Power UK



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invest in more non-commercial, strategic storage. The current provision of storage is inadequate – a weakness that has had a greater effect on security than events outside the UK in the past few years.

Walking the talk: deploying CCS

If power companies have too little confidence in CCS to fit it now, then more needs to be done to reduce the technical and economic risks. A number of countries including the UK are moving ahead with full-scale demonstration plants. This is welcome. However, there are significant uncertainties about how many of the plans for demonstrations will become a reality. Implementing a dedicated funding mechanism for CCS at EU level will be essential to reduce these uncertainties.

The UK should support more than the single demonstration plant it is currently funding. The current policy places all of the UK's CCS eggs in one basket. But it is not yet clear which variant will deliver. In view of this uncertainty, there is scope to relax the overall emissions standard to account for their demonstration status.

Supporting several plants that use a variety of technologies and fuels would reduce the risks of supporting CCS. This would help the UK government to maintain its leadership position, and use it to good effect as a global climate deal becomes ever more pressing.

** Ivan Scrase and Jim Watson are part of the Sussex Energy Group (SEG), SPRU, University of Sussex. This viewpoint is based on SEG's response to the Government's 2008 consultation: 'Towards Carbon Capture and Storage'. The full response is available at www.sussex.ac.uk/sussexenergygroup/documents/seg_spru_captureready_response.pdf*

RPI-X@20: a plan for regulatory regime change

Reports of the death of RPI-X have been greatly exaggerated. However, in March 2008,[i] and again in October,[ii] Alistair Buchanan (CEO of Ofgem) set out his plans for long-term reforms to RPI-X regulation in Britain. Is this the beginning of the end of RPI-X asks **Graham Shuttleworth***?

At one level, it seems unlikely that the RPI-X formula will disappear, since that is all it is – a formula, for updating price caps from year to year. As a formula, it had – and still has – its uses, but it has never fully described any regulatory system, let alone the British one.

More important is the process of defining P_0, the starting value for the RPI-X formula. The value of P_0 depends on how costs are defined, and how costs are converted into revenues at the start of a regulatory review – the hard stuff of regulation.

In the coming months, Ofgem will have to decide whether the RPI-X@20 workstream reflects a real need for regime change or just an opportunity for some much-needed housekeeping. Whatever emerges, it will not be a return to the "simpler" regulation of the early 1990s, which some still regard as the essence of RPI-X regulation.

What appeared to regulators as "simplicity" appeared to others as arbitrary and opaque decisions that undermined the incentives RPI-X regulation was supposed to create. A return to those days will not be possible, not least because section 178 of the Energy Act 2004 now obliges Ofgem to apply principles that are "transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed".

Buchanan's own speeches list a number of topics that fall into three broad themes: (1) Housekeeping – tidying up all the different, and potentially conflicting, incentive schemes; (2) Investment Incentives – encouraging companies to spend money (efficiently), instead of minimizing all costs; and (3) Alternative Dispute Resolution – finding ways for regulated companies to settle issues with stakeholders, before approaching Ofgem.

The first of these is uncontroversial, but requires hard work by Ofgem staff. The second is highly desirable, but will require even more hard work. The third looks like an appeal for "simplicity", perhaps to offset all the hard work required by the other two themes, but in fact it represents the greatest challenge to current regulatory methods.

Housekeeping

Let us start with the first theme, housekeeping. Distribution companies now face a number of incentives, each designed to address a specific problem: the Information Quality Incentive matrix, Registered Power

Zones, DG connections, losses incentives and ex post capex reviews, to name but a few. New environmental policies and programmes are accumulating all the time and the Energy Act 2008 just adds to the list of areas where incentives will be needed.

In practice, these incentives are not necessarily untidy, but it remains uncertain how the networks will interpret them and how Ofgem will apply them, especially since some (like the IQI) are only applied ex post at the next review. A lot of this uncertainty would disappear if Ofgem accompanied the announcement of each incentive with detailed regulatory accounting rules to define which costs fall under which scheme and how they should be recorded.

Progress on each scheme could then be monitored annually, allowing the accounting to be corrected immediately, if rules have been mis-specified or mis-interpreted. However, this would require Ofgem to give more detailed attention to accounting than has been customary in the past.

Investment incentives

The second theme in Buchanan's speeches is a greater focus on investment incentives. This theme will also require more detailed work at regulatory reviews than has been usual. Investments in individual networks are idiosyncratic. There is no magic formula or silver bullet that is going to define "correct" investment levels for each network.

Ofgem will have to get down and dirty in investment planning processes and projects if there is any desire to offer proper incentives. Incentives will have to offer a greater chance of 100% cost recovery (including the proper rate of return) and ex post reviews are likely to play a greater role (how else will Ofgem stop investment costs escalating?). However, this combination represents a challenge to Ofgem not to use 20/20 hindsight when deciding how projects should have been run.

In the past, Ofgem has criticised network companies for letting the costs of a project run out of control, because the company did not transfer the risk to the contractors. Unfortunately, networks cannot know which projects will turn out badly and which will come in under budget. Saying that the companies should have managed only the bad projects differently is like saying that they should only insure the sheds that burn down. The only "transparent" and "consistent" alternative is to apply the same rule to all projects. Is Ofgem really ready to let networks recover the higher cost of transferring risk to contractors for all their projects, even the ones that turned out to be cheap?

Such decisions are unavoidable at any regulatory review. The real challenge for a resource-constrained Ofgem will be recognising that greater focus on investment means less focus on something else – so what should be dropped from future reviews? I would vote for opex benchmarking, which is crude, arbitrary and could be replaced by using today's opex less a couple of percent.[iii] Networks will still have an incentive to reduce opex, but possible savings now fall within quite a narrow range, so even intensive scrutiny of opex does little to remove forecasting errors. In any case, does anyone really believe that opex benchmarking produced more accurate forecasts of future opex?

Alternative dispute resolution

Finally, we come to the third theme, the search for alternative or "simpler" methods of reaching agreement between companies and stakeholders, without involving regulators. Buchanan referred to the settlements that are a common feature of regulation in the US and Canada. However, he quotes papers by Littlechild et al, which describe the settlements without mentioning the years of hard work that went into defining the regime that makes such settlements possible.

As anyone knows if they have participated in arbitrations or 'alternative dispute resolution', such routes to agreement only work because there is a solid framework of contract law which tells contracting parties what kind of outcome a formal court case would decide.

Similarly, regulatory settlements only work if the regulators have previously written down in immense detail exactly how they would carry out a formal regulatory review, so that everyone can predict the likely outcome. Regulated companies and their stakeholders cannot negotiate in a vacuum and anything they do agree has to be consistent with the legal obligations of the regulator. Companies can only negotiate with stakeholders once they know what the regulator would decide. Such settlements are therefore only an alternative route to resolving disputes – not an alternative method of regulation.

So, if Ofgem really wants to simplify RPI-X regulation in Britain, and to clarify investment incentives to boot, it should start by codifying precisely and in detail how it would convert network costs into the value of P_0 at future regulatory reviews.

That really would be a regime change.

Graham Shuttleworth is a director at NERA Economic Consulting.

[i] Alistair Buchanan, "Ofgem's 'RPI-X At 20' Project", Speech at SBGI, 6 March 2008.

[ii] Alistair Buchanan, "Is RPI-X Still Fit for Purpose After 20 Years?", Beesley Lecture, 2 October 2008.

[iii] I am assuming there would also be some adjustment for growth in volumes, such as that provided by a price cap formula.