



## **BWEA Response to Regulating Energy Networks for the Future: RPI-X@20 Principles, Process and Issues**

The British Wind Energy Association (BWEA) is the leading UK trade association in the field of renewable energy, with over 450 corporate members representing the large majority of the wind energy business in this country. Wind energy is the fastest-growing renewable technology in the UK, and it will make an increasingly significant contribution to our electricity supplies over the next decade and beyond. BWEA also represents the interests of the emerging wave and tidal stream energy sector, building on its experience in the development of offshore wind. The development of UK power networks will largely be driven by the need for more renewable generation, and consequently the needs of such generators for timely provision of grid capacity at reasonable cost. We hope that Ofgem will therefore give appropriate weight to our comments.

BWEA strongly supports the RPI-X@20 Review process. We have previously identified issues with the current framework which have been in need of reform. This review rightly takes both a fundamental and holistic approach to the regulatory frameworks necessary to meet the emerging challenges of the next decade. It is a time of unprecedented change, coupled with enhanced responsibilities and new objectives. Central to the challenges ahead is the need for timely and adequate investment in our energy networks. The review should ensure that this objective remains in sharp focus.

We suggest that key challenges are:

- The future is uncertain, with many of the policy objectives and drivers poorly defined as yet. The carbon reduction framework being put in place by Government is starting to resolve some of these issues, but it is at an early stage as yet.
- With technological change and other drivers putting much uncertainty into play, it is not clear if we need “big” or “small” networks.
- The LENS project has opened up a lot of issues, and made clear the widely diverging paths that the networks could take in the future.
- Any revised approach will have significant impact on the next TPCR, and indeed the current DCPR.

Key initiatives for further development in the next phase of the project are:

- Choice of regulatory framework – radical reform or enhancement/reform of the existing framework with appropriate incorporation of new challenges?
- Clear delineation between responsibilities of regulated network companies for their regulated businesses and the additional policy objectives [environmental, sustainability, fuel poverty etc] which they may be asked to facilitate. It will be necessary to ensure they are not exposed to unacceptable risks that they are unable to control or manage effectively.
- A focus on the need to deliver significant sustained investment in networks over the coming decades. Proposed reforms should be tested against their ability to facilitate this central objective. The reform of the regulatory framework should ensure that uncertainty is minimised and a clear, stable platform is created for investment decisions. Given the scale of the challenge, it is essential that an appropriate balance of risk and reward is achieved by any revised framework.

We agree that the revised regulatory framework needs to provide clear guidance, appropriate encouragement, flexibility and incentives for network companies to facilitate the delivery of Government's sustainable development agenda. However, this should complement, not supersede, the fundamental role of networks in providing safe, secure, efficient and fit for purpose energy delivery services.

## Chapter 1

### **Question 1: Do you have any comments on the rationale for the review?**

The energy sector is facing new and uncertain challenges, therefore the rationale appears appropriate. As with all processes, it is necessary to periodically stand back and assess the fundamentals, rather than just extrapolate or refine. The Review also allows for the considered inclusion of new responsibilities for the networks, reflecting Ofgem's own enhanced responsibilities and a more strategic overview.

### **Question 2: Do you agree with the proposed scope of the review?**

Ofgem has suggested that it should take a step back and undertake a more fundamental review of the objectives and boundaries of regulation, as well as methodological issues. This needs to be done in a holistic way rather than looking purely at the individual networks in the energy supply chain.

However, we would urge caution in the determination of the scope of the project. As important as what is in scope are the agreed boundaries of the project. Too broad a scope risks an outcome of uncertainty piled on uncertainty. The objective must be to deliver something tangible, workable and useful. If the decision is made to move away from an "RPI-X" based framework, a key consideration will be the design of a seamless transition from one regime to the other, such that uncertainties are minimised, discontinuities are avoided and stakeholder confidence is preserved.

We agree that the two phase model is appropriate – it allows a balance to be struck between option identification & consideration and detailed, effective assessment of preferred framework(s).

We note that the "visionary" phase will culminate in the publication of an emerging thinking consultation document in November 2009. Given the very wide scope of this phase it will be important to allow sufficient time and process for stakeholders to effectively engage and influence, prior to Phase 2.

Options development phase: The second phase will involve the narrowing of the scope of the project and a detailed working up of options identified as having high potential. We look forward to further details on who will make the decision as to what has high potential, and what criteria will be used in coming to this judgement.

This phase of the project will culminate in a set of conclusions and recommendations that will be delivered to the Authority in summer 2010.

Whilst not being explicit, the Review appears to consider network companies having characteristics very like those that currently exist. We wish the Review to fully consider how new network companies, such as OFTOs, will fulfil their obligations to deliver the enhanced range of responsibilities and duties (including strategic investment) which will form part of the new regulatory framework.

**Question 3: Do you think the proposed themes for RPI-X@20 are appropriate?**

In considering the proposed themes for the Review, it is important to ensure that the previous “primary focus of energy network regulation” is neither lost nor given insufficient consideration. Operating efficiency, under whatever high level goals are set for network regulatory policy, will continue to be important. Security of supply lies at the heart of network design, operation and investment. Inappropriate decisions in this area are likely to have severe consequences and not be capable of either quick or easy reversal. We note that these issues are within the “themes” below. However, they require specific and appropriate attention.

With regard to “The primary themes”:

- Focusing on consumers’ needs: an effective regulatory regime will ensure that we and the networks focus on meeting the needs of consumers (current and future). This means engaging with consumers, understanding their needs, and ensuring that networks provide value for money and quality of service.

Care needs to be taken in the specific interpretation of this theme. Consumers are not always in possession of sufficient information in order to provide a *strategic* or *longer term* description of their needs. They are easily able to describe their immediate *wants* which are not always consistent with the most efficient or effective longer term outcome for their *needs*. This is particularly relevant for networks, given their relatively long asset life and capital intensive nature. We would suggest that the constituency should be widened from consumers to (as a minimum) include network *users*. By definition, network users will be taking into account in their longer term business plans those factors which will influence both their own, and their customers’, needs from a regulated network business.

- Delivering a sustainable energy sector: an effective regulatory regime will encourage regulated networks to facilitate the delivery of a sustainable energy sector. This incorporates security of supply, climate change targets and ultimately the low carbon economy, and social objectives (e.g. for fuel poverty).

We endorse the recognition of the role that networks have in facilitating the delivery of a sustainable energy sector. The key element in this theme is *facilitation*, responsibility for actual *delivery* will be shared across a number of stakeholders, which will include networks. This distinction is important. Further, the “roll up” objectives and considerations which are placed upon networks needs to be tightly focussed and specific. It is not the primary role of networks to deliver social objectives or climate change policy, nor should it be. Care needs to be taken in order to avoid project “scope creep” and insufficiently focussed objectives such that they become meaningless in practice or ineffective as a guiding tool to use in decision making.

**Question 4: Do you have any views on our proposed approach for engaging with stakeholders?**

The approach outlined in the document appears to be offer a wide spectrum of opportunities for engagement. The value of workshops/seminars and consultations lies in the opportunity for stakeholders to constructively engage and feed back. Subsequent processes need to ensure that the insights and knowledge gained thereby are adequately incorporated into the Review and equally importantly, stakeholders have a clear understanding of how their contributions have added value.

The initiative to establish small working groups to develop thinking on specific issues during 2009 is welcome. Properly constituted and effectively run working groups provide an important means of developing detailed and complex issues. They also promote ownership of identified solutions. We look forward to details of the Working Group process being published soon.

Whilst the views and ideas of a range of stakeholders are also provided through Ofgem's high level Advisory Panel and other existing Ofgem processes, it is worth considering whether these processes capture the full range of expertise available on the issues. Whilst network regulation can include elements which are specific to a particular jurisdiction, European and wider international experience in considering the relevant issues may be of benefit. We support the intention to explore and test relevant experiences from network regulation in other sectors and other countries.

One area which network regulation will increasingly have to deal with is that of interconnection, in the context of the single European market in energy. Whilst the issues surrounding strategic investment in energy networks, on a national basis, have recently been explored via the ENSG and other fora, effort could usefully be directed towards the issues associated with strategic European interconnection.

**Question 5: Do you have any comments on the timetable for the review?**

The timetable appears appropriate to the scope and depth of the Review. The Working Groups need to be set up and operational as early in the process as possible.

Chapter 2

**Question 1: Do you have any views on our aims for RPI-X@20?**

*RPI-X@20 aims to ensure that an effective regulatory framework for energy networks is in place that delivers choice and value for consumers, and places appropriate incentives on companies to facilitate efficient delivery of a sustainable energy sector. This is in line with the Authority's primary duty.*

We reiterate our comments above, with the additional observation [self evident but important] that for the core energy networks, it is not a matter of choice of network

– as a single network is the most cost effective outcome – but that the network is *efficient, effective*, and facilitates choice and value for its users.

Care needs to be taken in the specific interpretation of consumer needs. Consumers are not always in possession of sufficient information in order to provide a *strategic* or *longer term* description of their needs. They are easily able to describe their immediate *wants* which are not always consistent with the most efficient or effective longer term outcome for their *needs*. This is particularly relevant for networks, given their relatively long asset life and capital intensive nature. We would suggest that the constituency should be widened from consumers to (as a minimum) include network *users*. By definition, network users will be taking into account in their longer term business plans those factors which will influence both their own, and their customers', needs from a regulated network business.

We endorse the recognition of the role that networks have in facilitating the delivery of a sustainable energy sector. The suite of objectives and considerations which are placed upon networks needs to be tightly focussed and specific. It is not the role of networks to deliver social objectives or climate change policy in isolation, nor should it be.

We have the following comments on the more specific objectives of the review:

“To develop a regulatory framework that encourages licensees to:

- facilitate delivery of a sustainable energy sector by developing and maintaining an appropriate, efficient and effective network;
- invest appropriately in networks;
- strive for increasing efficiency, innovation and appropriate quality of service; and
- respond appropriately to the agreed needs of current and future consumers.”

We agree that given the uncertainty that the sector faces, any regulatory framework must be sufficiently flexible to adapt to changes in the energy industry and the wider economy. However, it must also provide an appropriate degree of stability such that the necessary confidence can be established to allow significant network investment to proceed in necessarily long lived assets.

RPI-X@20 will be a success if the final outcome results in a regulatory framework that provides the networks that current and future stakeholders need, in an efficient and timely manner.

**Question 2: Do you think the principles for undertaking the review are appropriate and sufficient?**

Yes. We endorse the primary commitment that change will not be implemented for change's sake. Amendments to the current regulatory regime will only be made where there are clear *agreed* benefits in doing so.

Consultation: We have already noted the need for timeliness, given the considerable scope and scale of the review, as well as the benefit of adequately resourced Working Groups – on specific issues.

No surprises: This is particularly important. There must be no discontinuities in the evolution of Ofgem's thinking and the rationale underpinning the final recommendations that are eventually taken to the Authority.

Better Regulation: It is to be welcomed that Ofgem has restated that it will remain accountable for the conclusions that are reached as well as the process that is followed.

No retrospective action: We endorse the principles of no retrospection and no stranding of efficient investment. We look forward to the safeguards which will be developed to ensure that this actually occurs. Of particular importance will be the protections built into the transition arrangements that will be required for any new regime and to deal with "the potential stranding of future efficient investment in any new regulatory framework."

We look forward to further detail being provided on these important issues.

**Question 3: Do you have any views on our proposed approach to the review?**

The approach appears to be comprehensive. It will be useful to understand the processes by which Ofgem decides, from such a vast body of information and in some cases competing network regulatory philosophies, which themes will be prioritised for further investigation and analysis.

**Question 4: Do you have any comments on the inter-relationships between RPI-X@20, other Ofgem projects and EU and national policy developments?**

It is vital that that the Review is manageable and delivers meaningful outputs in areas which are the direct responsibility of Ofgem. As such it will be as important to define the *boundaries* to the areas considered by Review as it will be to attempt to ensure every last inter-relationship is explored.

One area which network regulation will increasingly have to deal with is that of interconnection, in the context of the single European market in energy. Whilst the issues surrounding strategic investment in energy networks, on a national basis, have recently been explored via the ENSG and other fora, effort could usefully be directed towards the issues associated with strategic European interconnection.

Chapter 3

**Question 1: Are the original principles of RPI-X regulation still valid?**

A reformed regulatory framework will need to deal effectively with the need for sustained long term capital investment, rather than asset sweating.

Planning and regulating long-term network investments will continue to be a major feature in the UK and this needs to be got right.

There is a need to ensure that the network companies are properly equipped for, and have the necessary resources to deal with, the enhanced and additional range of duties and obligations. This is in addition to the existing requirements to provide secure and flexible networks – rather than just opex sweating

The need for the development of new and appropriate methodologies for regulating service levels and quality (target setting and reward-penalty regimes).

So, the question is: Has RPI-X **successfully** absorbed these needs? If not can it be made to? If not what can do the job?

**Question 2: Do you have any comments on our description of the context of energy regulation since privatisation? Are there any issues or events relevant to the regulation of energy networks that we have not considered?**

No.

**Question 3: Do you have any comments on our description of the evolution of network regulation since privatisation?**

No.

**Question 4: Do you think our description of the existing regulatory framework in electricity and gas transmission and distribution is the appropriate base case (starting point) for RPI-X@20? Is it appropriate for us to consider electricity distribution regulation using developing proposals from DPCR5?**

Yes.

**Question 5: What lessons do you think RPI-X@20 can take from the history of energy regulation?**

The RPI-X regulatory framework has served the UK well, and been capable of adaptation to new challenges. Given the period over which it has been in place, significant incremental changes to its makeup have occurred. Whilst each of these changes in isolation may be seen as a distinct response to a particular issue, it is timely that the current framework is reviewed on a *strategic, holistic* basis.

The challenges facing network regulation change over time. Regulatory frameworks applied to networks and network companies also need to evolve in response to these challenges. Key lessons for RPI-X@20 include:

- Recognition of the inability to secure perfect regulatory foresight, in the approach to setting frameworks. The regulatory framework therefore needs to be sufficiently flexible in order to adapt to new circumstances and incorporate new objectives.
- The need to provide a regulatory environment which promotes confidence with regard to the “regulatory contract” between the regulator and stakeholders, on a continuing basis.
- An appropriate balance of certainty, simplicity and flexibility.

**Question 6: Do you have any comments on our assessment of the performance of the network industries since privatisation?**

It should be noted that performance has largely been based on a limited number of clear, specific, deliverable objectives. Performance has been subject to an investment and incentive regime influenced by an understanding of the regulatory contract between regulator and stakeholders and consequent acceptable level of *regulatory risk*.

**Question 7: Do you think our description of energy networks and the regulatory framework today (the legacy of RPI-X) is accurate? What do you think the implications of this legacy are for RPI-X@20?**

See answers to Questions 5 and 6 above.

On the specific points offered in the Consultation:

- low risk and potentially risk averse (in their culture, and in operational, organisation and financial choices);

It is for debate whether a network company should be at a more “risk embracing” point of the spectrum than that currently experienced. Enhanced risk requires the incentive of enhanced reward and the ability to accept significant losses [these “losses” may not be limited to financial ones and may be borne by others, not the companies themselves]. Both of these ultimately translate into increased costs for consumers. There needs to be a substantial proven benefit for consumers before moving to a new point in the risk spectrum.

- willing to undertake investment only when commitment is provided by users and/or the regulator that the investment will be allowed into the regulatory asset base;

See comments above. Investment by a regulated network company should not be undertaken lightly or on an unduly speculative basis. The concerns of users include: how much user commitment is required and when; how long the investment delivery

timescales are from the point of decision; and the length of the investment decision process itself.

- focused on allowed revenue and less concerned about the structure of network charges that can have a significant impact on the need for network investment and on the costs faced by consumers and different groups of consumers (for example business and domestic customers);

We find the assertion regarding the structure of network charges curious. Network companies devote a significant proportion of their time considering charging and investment. If the costs which are derived from these processes are cost reflective, then modification of those costs by reference to “different groups of consumers” could have the effect of undermining investment signals and overall efficiency.

- more focused on Ofgem, and understanding how to ‘beat’ the regulatory contract, rather than on understanding their own consumers’ needs and being rewarded for improving customer service;

The degree to which this may or may not occur in practice is a characteristic of the regulatory regime under which network companies operate, and the incentives that they respond to.

**Question 8: Are the identified challenges the right ones? Are they new challenges not previously addressed? Are they short-term (temporary) or permanent challenges? Are there others that we should consider in RPI-X@20?**

We agree that the energy networks sector is expected to play a leading role in delivering a sustainable energy sector for the future. Whilst there is significant uncertainty about what this means for the future role and direction of networks, it should not lead to extended review, debate and reconsideration. Networks are capable of significant flexibility in meeting future needs and the pressing drivers of near and medium term consumer requirements should not be downplayed. A robust, secure and flexible network can accommodate a wide range of challenges presented by developing energy and environmental policy.

The challenge for the regulatory framework going forward is to ensure that the significant sustained investment in energy networks which is required is made in a *strategic manner*, rather than an accretion of isolated, sequential, case by case decisions. This will necessarily involve a degree of quantified risk in the investment process. The challenge is to develop a framework which minimises these risks, allocates risks to those best able to manage them and then operates effectively to *deliver* the required investment. Within this framework, financeability will obviously be of primary importance.

Considerations regarding cost allocation, charging and equity are important and should not be neglected, but without primary network infrastructure in place to facilitate efficient energy markets, become second order issues.

## Chapter 4

**Question 1: We present a number of issues that we will consider when assessing the processes that we and networks use to focus on consumers. Have you any views on these issues? Are there others that we should also consider?**

Engagement with consumers: This is an area which requires balancing several objectives, and needs to be considered carefully. Ofgem should provide both a facilitation service such that consumers can more efficiently engage in the regulatory process whilst at the same time acting as a “critical friend”. There is little merit in increasing involvement by consumers without a minimum level of understanding of the issues that are being considered. In the absence of adequate and appropriately skilled resources to enable a valid contribution to be made to the necessarily complex issues involved, the net result risks being an ineffective addition to the regulatory burden.

In the absence of a “future consumer” representative organisation, which is highly unlikely, the interests of future consumers are best served by consideration of the evolving impacts of policy development on current and continuing consumers. This is an area where established consumer groups and Ofgem have a role in definition, scenario development, implications of policy choices and subsequent impacts on future networks.

Ofgem rightly acknowledges the central role that all companies along the supply chain have (i.e. producers/generators, transmission and distribution networks, and energy suppliers). Since it is these companies which are continuously dealing with final consumer needs [to a greater or lesser extent], then they need to play a core role in any regulatory process intended to improve the focus on consumer needs.

Where energy supply companies are engaged in the regulatory process, they will necessarily be representing the interests of final consumers. However, care needs to be exercised when considering what, if any formal responsibilities may be placed on energy supply companies.

The basis for engagement should not place an undue or inappropriate burden on the industry. Consumers and network users’ needs should not need to be constantly re-iterated. It is worth considering the intentions behind the recent planning reforms. Relevant National Policy Statements are intended to avoid the unnecessary and repetitive consideration of high level issues which form a backcloth for specific planning proposals. Applying this principle to network regulation, the focus of engagement should be at the end of the spectrum concerned with policy proposals and detailed consultations.

Complexity: Regulatory controls and processes mirror the activities which they seek to regulate, which themselves are necessarily complex. The degree of complexity

largely reflects the desire to achieve outcomes which are in a narrow band of uncertainty. If the complexities do not allow full engagement by certain groups of stakeholders, then the question is whether simplification and [possible] fuller engagement would lead to more desirable outcomes, or simply to greater uncertainty which all had been more fully involved in?

There is a legitimate industry concern that equivalent outcomes could be achieved and levels of risk managed with less complexity – and the ensuing regulatory burden. The regulatory regime needs to focus on outcomes, rather than excessive process detail, and test the required degree of complexity against that template.

Network engagement with consumers and network users: Engagement occurs with users at present via a variety of mechanisms and timescales, either directly, in response to consultations, as part of joint bodies/forums or governance processes. The review needs to consider whether these mechanisms provide the appropriate level of user engagement and whether that engagement results in users' views being properly reflected in network company processes. It is our view that the level of engagement could be significantly improved, particularly in areas such as:

- Greater and earlier transparency with regard to network business plans;
- Appeal processes which allow users to participate more fully and on a more informed basis.

Given the difficulties of prescribing an externally devised workable solution, encouragement rather than requirement should be pursued, with the backstop of more direct action in the event that self-generated reform proves to be ineffective.

Of particular concern is the *time* taken between users identifying significant concerns, and action taken on behalf of both regulatory authorities and network companies to address those concerns. Reform needs to address this as a central issue.

**Question 2: We present a number of issues that we will consider when assessing how the regulatory framework encourages networks to meet the needs of consumers. Have you any views on these issues? Are there others that we should also consider?**

**Identifying what consumers need: How do we identify what consumers need? Is this the role of the regulatory framework or for networks to do themselves?**

See our responses to previous questions. Identification of consumers' [and, importantly, users'] needs is best achieved under the multi-strand approach that we have outlined:

- a coherent policy framework, with consequent direct and indirect responsibilities defined;

- an effective engagement process for users, in network business plans and operational issues which affect them;
- the ability of consumers to make their contribution, via Ofgem, and other channels; and
- the ability of network users to represent their own customers interests and concerns.

**How do we determine what is best delivered through an overall ‘allowed revenue’ determination and through the range and structure of charges that determine who ultimately pays?**

See our response to previous questions. Charges should be cost-based and equitable. Subsequent modifications to charging structures for wider policy reasons should aim to preserve the cost reflective *principle* wherever possible. We make the distinction between *cost reflective* and *cost replicating*. The correct incentives for users, signalled through charges, can be provided without the necessity for full cost replication. In this way, volatility, unpredictability and consequent uncertainty can be avoided whilst still ensuring overall allowed revenue recovery. This facilitates the promotion of wider policy objectives, combined with appropriate user signals.

**Balancing objectives: How should we balance the needs of different consumers (including future consumers)? If incentives are not aligned, how do we balance the needs of users of the network with the needs of consumers? How do we balance demands for lower prices, better quality of service/network reliability, and delivery of a sustainable energy network? Should we or the networks be responsible for balancing these objectives?**

Value for money, efficiency and innovation: The existing processes for promoting “value for money” delivery by the networks are based primarily on measurable economic factors. If the regulatory framework is to be amended to place a greater emphasis on social objectives and qualitative outputs, care needs to be taken to ensure that the future economic tests remain both relevant and effective. There may be situations where the requirement to pursue social objectives results in costs being incurred which the economic framework deems to be “inefficient”. It is difficult to foresee how the network companies could invest with confidence without a clear unequivocal framework which effectively deals with economic and social objectives coherently.

Quality of service: It is difficult to determine the exact quality of service current and future consumers want, and the price they are willing to pay for that service. It will change over time, according to the effects on consumers in general or a particular group. If consumers were given the choice of a lower quality of service now, in exchange for a reduced bill, many would make that choice. How many would still make that choice is debatable, following poor experience of reduced service levels, but certainly less than the original number. Given that network investment is a long term proposition, under-investment leading to unacceptable quality of service levels will take a long time to correct. Whilst over-investment certainly results in increased

costs, it may also bring benefits in terms of network resilience, flexibility and functionality.

It is difficult to foresee how a tightly meshed core network could provide different levels of service to different classes of customer. However, lower level networks, particularly with “user choice” connections, can provide differentiated service levels.

Volatility of charges/Structure of Charges: Efficient networks cost money. Efficient investment in networks costs money. Users understand this. Concerns arise where the charges for using those networks are unnecessarily volatile and unpredictable. There must be consideration of cost reflectivity in the setting of network charges, but this does not necessarily mean that they should be fully *cost replicating*. Charges should be set in a manner which provides both the appropriate signals to users and recovers the allowed revenue for network companies. Within this overall requirement, there should be predictability over a reasonable period, the ability for users to hedge network charges if desired and arrangements to ensure that network related developments do not result in significant transitions for the charges seen by different groups of users [either on a geographic or network level – e.g. HV/LV – basis].

**Question 3: Are the issues different for gas and electricity, and for transmission and distribution?**

Our comments refer to electricity networks. Transmission and distribution systems do require separate consideration, due to their innate characteristics, but share common issues such as access, equitable charging regimes and the ability of users to engage constructively with the network providers.

Chapter 5

We note that Ofgem recognises that one of the key challenges is balancing security of supply, environmental targets and social policy objectives. The need to balance a range of objectives is a key deliverable for RPI-X@20.

**Question 1: Do you have any views on our description of the sustainability challenges facing networks? Are these new challenges? Are the challenges different for electricity and gas, and for transmission and distribution?**

The description of the challenges appears to be consistent. How much these challenges represent specific issues for networks alone, and how much they are a consequence of wider policy initiatives that networks need to be respond to, as part of the overall industry business challenge, is for further consideration.

**Question 2: We present issues that we think we should consider when assessing how decisions about what needs to be done by the networks are incorporated in the regulatory regime. Have you any views on the list of issues? Are there others that we should consider?**

- **A new challenge: Does delivery of a sustainable energy sector fundamentally change the way that networks need to make investment and operating choices?**

Network investment and operating choices need to be made against:

- A clear, consistent long term policy framework, set by government;
- A stable, coherent regulatory regime which is aligned with those policy objectives.

These apply across a wide spectrum of objectives which the energy sector may be tasked to deliver, including those related to sustainability policy.

- **Proactive networks: Should networks become more proactive when considering their role in delivering a sustainable energy sector? Should they make strategic decisions about their role? Should this be encouraged/incentivised by the regulatory framework or is a formal requirement needed?**

See answer to question above. Networks can only be “proactive” given a clear, stable long term policy framework. Companies make strategic decisions as a normal part of business operation. It is part of the role of the regulatory framework to “de-risk” those strategic decisions as much as possible, on behalf of consumers.

- **Role of networks: Will the role of the networks need to change?**

Given the probable changes and developments in distribution system operation and function, there will be an increasing requirement for more active management of distribution networks. As such there is merit in examining the scope and scale of the potential distribution system operator role. A proper examination of the role would need to be undertaken, incorporating lessons learned from the separation of responsibilities of the transmission SO and TO functions.

With regard to the transmission system operator taking responsibility for long-term strategic planning, care needs to be exercised. The GBSO rightly keeps under review a range of credible scenarios for the transmission network over various timescales. In order to move to the next step of strategic planning [and accompanying investment], the relevant core assumptions in the Plan need to be tested and endorsed by a wider stakeholder community [including government].

Considerable caution is required before introducing additional obligations on network companies which are both outside their core business areas and also rightly the primary responsibility of government. It is difficult to see what would be gained by placing more responsibility on Distribution companies for meeting fuel poverty targets and wider social objectives (e.g. regional regeneration), *in isolation*. It may be that as a consequence of government policy, action by government agencies or third parties, there are facilitating actions that a distribution company could undertake. However, these will be at the end of a primary process for which other

parties have the primary accountability and management responsibility. From this, clear actions, responsibility limits and cost recovery mechanisms may be considered to enable facilitation, where appropriate, by distribution companies.

- **Degree of regulatory intervention: Should it be left up to the networks to determine what they need to do to deliver a sustainable energy sector?**

Network businesses need certainty with regard to the framework against which they are required to plan, invest in, and operate their businesses. Government policy should provide the starting point for sustainability considerations, as it does for all UK industry. Any specific guidance, either statutory or regulatory, needs to be consistent, achievable, capable of being funded, and measurable. It should not place a differential or inequitable burden on the network companies or their customers.

- **Investment requirements: How do the networks determine an efficient balance between making better use of the existing network and investing to enhance or expand the network?**

Networks are composed of hard assets. The benefits of new technology are assimilated into network design, planning and operation on a continuous basis. Engineers have always optimised against a number of requirements. Once the appropriate, agreed security of supply criteria have been determined, other policy considerations can be incorporated. It is a matter for Government policy where the balance between efficiently incurred costs and delivery of sustainability goals is struck. What is important is stability and consistency in policy and application.

- **Keeping options open: We know, from LENS, that a range of plausible network scenarios may emerge in the future. There is value to avoiding long-term commitments to significant new assets and to experimenting and piloting trials of new technologies. How do we ensure that decisions made today do not close off options for the future?**

All businesses balance optionality against the costs of keeping options open and the potential paralysis of making no decision at all – and failing to deliver the required goods or services. Network companies are no different. Given the central role that energy networks play for UK plc, and the *relative* costs involved compared to the *value creation* that they facilitate, required investment should not be deferred due to theoretical, unavailable supposed “better value” options. Robust analysis of investment is fundamental, but the investment case should always provide preferential weighting to solutions which satisfy near and medium term consumer needs, rather than those which rely on *possible* but as yet *unprovable* radical future scenarios. The value creation supported by effective networks for near and medium term customers will always exceed the possible “option loss” of the networks for “long term future” consumers. Investment criteria to meet their needs will be developed and investment made, when the needs become sufficiently clear to be meaningful.

- **Interactions along the supply chain: do the networks need to interact with other parties along the supply chain when making decisions about investment to facilitate delivery of a sustainable energy sector? How might that interaction happen?**

Currently, network companies “interact” with other parties when planning and operating their assets. There are well publicised issues with the ways in which these interactions could be reformed. Ofgem are currently pursuing a range of initiatives in this area. Adding the requirement for “sustainability” does not fundamentally change the requirements for these existing processes. Alignment should be achieved along the “supply chain” by the fact that all those involved will be operating within the framework provided by UK Government policy and its particular implementation requirements for each sector of the economy. Just as there is a requirement for network companies to facilitate *competition* by the provision of an effective, economical network, there may be a role for them to provide a facilitation service such that those involved in the energy supply chain are enabled to discharge their own *sustainability* obligations in the most effective way.

**Question 3: We present issues that we think we should consider when assessing how the regulatory framework can ensure that any capital investment is efficient and is financed. Have you any views on the list of issues? Are there others that we should consider?**

- **Comparison with other investments:**

When considering the treatment of environment-related capital investment, there are parallels which can be drawn on from the regulatory framework for the Water Industry. Whilst not a complete template for energy, this does consider the interaction between different investment types. In cases where one capital project can deliver multiple objectives, the analysis becomes more complex. Given the imperatives of sustainable development and the need for investment, projects should not be subjected to undue additional financial criteria or conditions, where there are multiple objectives.

- **Investment plans: how do networks determine what investment is needed?**

Clearly, given the capital intensive nature and asset lives of energy networks, a compartmentalised five year period is inappropriate. There should be a continuum which incorporates strategic investment against agreed scenarios, medium term investment against agreed objectives and shorter term investment against firm plans. Five years is an appropriate period to *review* this overall framework of investment, but should not lead to dislocated policy changes, due to consideration of investment needs across all planning horizons.

Within this framework, the choice of whether to consider investment decisions on an aggregate basis or to review decisions on a project-by-project basis, will naturally become clear. It would be expected that there would be limited need for specific

detailed project reviews. Concerns regarding level, type, and timing of investment would also be capable of being addressed by a more holistic approach.

- **Anticipatory investment: would it be appropriate to encourage networks to undertake anticipatory or strategic investment (i.e. before they are certain about user requirements)?**

See answer to question on investment plans, above. With appropriate and sufficient stakeholder endorsement, strategic investment is possible against an agreed set of scenarios. Stakeholders would include Government, network companies and users. Risk/return issues and allocation would depend on the timeframe under consideration and the degree of uncertainty of the agreed scenarios. There would need to be a fuller examination of the issues surrounding “stranded assets” as it would be expected that investment would be made in good faith on this revised, more inclusive and agreed basis. Where unforeseen and radical events reduced the value of that investment, it appears inequitable that one party should bear the entire risks involved. However, in order to ensure that purely speculative investment was subjected to the appropriate checks prior to commencement, consumers and users would need the inclusion of an effective “stranding provision” for the network companies.

- **Monitoring efficiency:**

Regulatory monitoring of efficiency is an important function, which safeguards the interests of user and consumers. If the regulatory framework is such that the requirement for investment is subject to less uncertainty, then the focus of monitoring shifts from the decisions themselves to the benefits that they deliver. This would suggest that reasonable tests for costs and/or outputs would form the major part of efficiency monitoring.

- **Dynamic considerations and uncertainty: given the long-term nature of assets, and the potential for there to be step-changes in the design of networks, how can the efficiency of investment over time be considered?**

See answer to question on investment plans, above. There is also the potential to be unforeseen step changes in the usage of networks. Whilst network companies should be encouraged to plan and invest efficiently, the degree to which ex-post regulatory examination of uncertainty is beneficial to stakeholder confidence and improved outcomes is uncertain.

- **Delivery of investment: should investment that is needed be delivered by the networks or should contracting out be used?**

The networks should have sufficient regulatory incentives to deliver efficiently and provide value for money. If these are in place, then it will be for the networks to choose how they manage their investment plans. The most effective option for the particular situation or project will be chosen either in house, contracted out or some other variant. In a dynamic business environment, only the networks will have the

full information available to make the optimum decision. It should not be a matter for the regulatory framework to prescribe how their businesses are run.

- **Funding network investment: Delivery of a sustainable energy sector may require continuing subsidies for new technologies or in the absence of an effective carbon price signal from emissions trading.**

The funding of costs incurred by networks due to specific government sustainability policies and objectives should be a matter for Government, rather than the regulatory regime. Any such additional costs need to be clearly segregated and identified, such that all stakeholders are aware of their origin, magnitude and allocation/recovery method.

**Question 4: We present issues that we think we should consider when assessing how the regulatory framework balances risk and rewards. Have you any views on the list of issues? Are there others that we should consider?**

Facilitating the delivery of a sustainable energy sector will increase the risks that networks face. The nature and degree of risks will also change over time. Networks will be asked to accept responsibilities and carry out duties which are outside of their current business envelope. Where they are required to act as *agents* in the delivery of Government policy initiatives, then it is important that these activities are clearly identified, along with the costs and risks involved. Network companies may be offered incentives in order to facilitate efficient delivery of their agency roles. However, the fundamental responsibility for, and any associated risks with, these duties must remain with Government and not be transferred either implicitly or explicitly to network companies or the energy consumer.

- **Risk sharing: what is the current balance of risk between networks and network users, and between networks and consumers? Will this balance need to change in the future? What mechanisms might be used for sharing the risks?**

Currently, the regulator acts as a proxy for consumers' interests, in addition to determining where the balance of risk for any activity is eventually placed. Network companies are perceived as having to provide a significant and onerous "burden of proof" that investment is required. Once this is provisionally "accepted", there is an element of protection from ex-post review. Increasingly, retrospection appears to be a concern for those making investments with the best available information at the time. The focus should be on providing a framework which promotes confidence for all stakeholders that the "best decision" available at the time is made and then proceeding to *deliver* on it. Too much refinement and review in the delivery process adds to both cost and risk. There is a role for post investment review, but this needs to be couched in such a way that best practice is facilitated and encouraged for the *next* investment round, rather than backwardly focussed, seeking to "claw back" perceived *ex post* inefficiencies.

**Question 5: We present issues that we think we should consider when assessing how the regulatory framework can encourage innovation by the networks. Have you any views on the list of issues? Are there others that we should consider?**

The encouragement of innovation requires complementary consideration of the risk/reward balance associated with that innovation, for the network companies. In non-regulated industries, the rewards for successful innovation can be significant, with little of the benefits being passed on to consumers, for a significant period. Likewise the outcome of “high risk” innovation can be business failure. It is for debate how “innovative” stakeholders wish network companies to be without appropriate engagement. Whilst the culture of some network companies may arguably be less entrepreneurial than some in other sectors, a culture of safety, detailed engineering competence and excellent risk management is highly valued by users. An area where network companies could provide users with an enhanced experience is that of supporting users and consumers who themselves identify a source of innovation or benefit. Experience in this area suggests that either this valuable source is under-utilised or the incentives currently provided for network companies are insufficient for them to develop and support user originated innovation and reform.

**Question 6: Are we addressing the right issues and questions in the 'Delivering a sustainable energy sector' theme? Are there any issues missing from this theme?**

We agree that the issues are relevant. We restate the need for consideration to be guided by a clear, comprehensive policy platform, provided by Government. This in turn will reduce the uncertainties which both Ofgem and the network companies face when considering the practical implications for the regulatory framework required to facilitate the relevant policies.

**Question 7: Are there issues that need to be covered in RPI-X@20 that are not adequately captured by our two themes? Please specify what these issues are.**

Please see answers to previous questions.

## Chapter 6

**Question 1: We have presented a number of ideas on changes that could be made to the existing regulatory framework. Are there other alternative frameworks that you think RPI-X@20 should look at?**

We note that the main view from the two industry workshops held by Ofgem appeared to be that RPI-X was “not necessarily broken” but that there was a need to make changes to it, particularly to ensure that investment required for delivering a sustainable energy sector was undertaken efficiently.

It is for the Review to fundamentally examine the merits of different approaches and present them in a way such that stakeholders can properly assess the options and associated benefits. However, we strongly recommend that transitional issues are given sufficient focus, if the decision is made to move to an alternative framework. The industry and the network companies will require a transition process which is seamless, does not add to uncertainty and promotes investor confidence.

**Question 2: Do you have any provisional views on any of the ideas presented here?**

The issues identified under “Tidying up the existing regulatory framework” appear to cover a wide range of approaches for enhancing and adapting the existing framework. We look forward both to Ofgem’s rationale for deciding whether or not to pursue this course and; if appropriate, more detailed information on how each of these potential features will be evaluated.

**Guiding mind:** in other sectors, the economic regulator and the regulated business is provided with guidance on what the policy objectives are and, in some cases, what needs to be done to deliver them. There is a fundamental question as to whether guidance of this type should be provided or whether these decisions should rest with the market.

The issue is complex. Government will rightly set out policies which have an impact on the energy sector, and networks in particular. Some of these policies will carry direct implications for those affected. In other areas it is possible that differing or conflicting interpretations of policy could be assumed by different stakeholders, leading to uncertainty. There is a role for Government to provide clarity to industry, the regulator and consumers in these circumstances. Further, there are situations where an interim step is required between long term policy, and delivery, either by the market or by regulated entities. This step can be delivered by a suitably constituted body. The recent work of the Energy Networks Strategy Group on clarifying the parameters of a Grid network to deliver “2020” and other energy ambitions is a case in point. It is debatable whether this constitutes a “guiding mind”. However, there does need to be a formal mechanism to achieve clarity, where policy issues impact delivery. The constitution of any advisory Group should not exclude or override the legitimate interests of other stakeholders.

**Changing the role of the networks and the system operator:** A review of the alignment of incentives between the TO and SO will be central to an assessment of their roles. It has also been suggested that we should consider whether a separate system operator may be needed on distribution networks.

It has been clear for some time that TO and SO incentives need better alignment. It may also require an examination of both the individual and combined risk/reward balance for the SO and TOs.

A system operator may be needed in future for distribution networks, but the nature of any potential role is dependent on the way in which the networks themselves evolve, which Ofgem has noted is subject to uncertainty. More active networks, requiring real time demand/generation management would certainly require optimisation by a system operator, together with a formal "system to system" management role between the distribution network and the transmission system.

Where enhanced sustainability duties form part of the network role, the distribution system operator/owner may have a much greater involvement with the customer than at present, potentially encompassing direct relationships in areas such as energy services.

**Tendering:** we are currently developing tendering proposals for the offshore transmission regime. It has been suggested that tendering of this type could be used more widely. We may also need to consider whether the networks' current procurement practices are efficient and whether more formal requirements for contracting-out are needed.

We agree that there is merit in examining whether the networks' current procurement practices are efficient – this forms a standard part of any regulatory framework.

Given the minimal experience with the operation of the proposed tendering process for offshore transmission, and the considerable concerns which have been raised with respect to the process, we believe that it is premature to consider any extension of this process. Following actual experience, where any benefits can be properly assessed, stakeholders will be able to contribute based on practical experience, rather than speculation.

**Franchising all or part of network operations:** it may be possible to franchise the right to operate particular parts of a network or the right to undertake particular activities (e.g. a new distribution system operator role). The design of franchising or concession arrangements would involve a number of key decisions including: who decides what is franchised; how long is the franchise for; what are the criteria for awarding the franchise; is the franchisee subject to a regulatory control and, if so, is it the same as the current regulatory framework?

Great care needs to be taken prior to the consideration of franchising. The experience of other regulated networks [e.g. the railways] does not appear to provide clear evidence of the benefits of such an approach for consumers, or indeed other stakeholders. The opposite would seem to be the case.

Franchises would require significant additional regulatory safeguards to be put in place to ensure that:

- consumers and existing network companies were fairly treated when "incentivising" franchisees;

- the regulatory and administrative burden did not far outweigh any phantom “efficiencies” claimed for the franchise;
- corners were not cut by franchisees who had no long term stake in the networks;
- the existing TOs and DNOs were not placed in the invidious situation of being the “dustbin of last resort” with the ultimate responsibility to ensure responsibilities were met.

**Capacity Auctions:** Making more use of auction mechanisms in the regulatory framework has been suggested.

We have previously made our views known on the place of auctions in the network regulatory framework. We do not endorse their use.

## Chapter 7

### **Question 1: Do you have any views on the proposed next steps for the review?**

There will be a significant stakeholder input into the process, via responses to this Consultation. It would therefore be useful to have a fuller opportunity to understand how this process has developed Ofgem's thinking, in advance of the next formal consultation, planned for November 2009. This appears to be the last stage at which issues will be “open” prior to the final consultation on the proposed recommendations, in late spring 2010.

We note the high level proposals for ongoing stakeholder engagement include working groups, workshops and seminars. Firm details on these, their dates and content would be welcome, particularly the role, composition and timescales for the Working Groups.