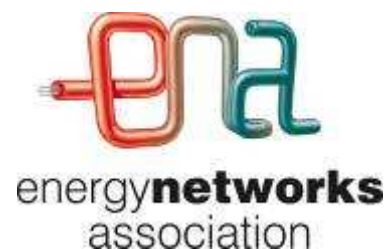


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23 April 2009

Dear Hannah

**REGULATING ENERGY NETWORKS FOR THE FUTURE: RPI – X@20
PRINCIPLES, PROCESS AND ISSUES**

We are pleased to have the opportunity to comment on the first consultation document on the very important RPI – X@20 review which Ofgem is currently undertaking.

While we recognise that the review is currently in its 'visionary' stage and that, therefore, many ideas are canvassed in the document, we restrict our comments to what we take to be some of the most important themes which run through the document, specifically:

- the objectives of RPI – X@20;
- the challenges facing Ofgem and the network companies, and the conclusions to be drawn from these;
- Ofgem's assessment of the relationship between the performance of network companies and the RPI – X regime;
- Ofgem's attitude to risk and uncertainty;
- the issue of who decides what networks should be delivering;
- the related issue of the role of the energy networks.

Objectives of RPI – X@20

Ofgem's own statement of its objectives (paragraph 2.4 in the consultation document) lists the following objectives:

- facilitate delivery of a sustainable energy network;
- invest appropriately in networks;
- strive for increasing efficiency, innovation and appropriate quality of service;

- respond to the needs of current and future consumers.

We are happy with this list of objectives although it will be important to recognise as the review progresses that some of them may conflict with each other. In particular:

- the drive to deliver a sustainable energy sector comes largely from government policy and long-term targets for carbon emissions and renewable energy, and will be expensive;
- current consumers show no obvious appetite for that expense and, in the words of consumer research recently published by Ofgem, ‘struggle to consider how life would be different in 20 years time, and particularly find it hard to consider the “bigger picture” such as large-scale societal and demographic changes which might have an impact on the energy market’.¹

In our view, this tension and how it is resolved is at the heart of several of the issues which Ofgem plans to consider as part of the RPI – X@20 project. This also includes, for example, the respective roles of consumers and a governmental ‘guiding mind’ in determining what network investment is undertaken.

Challenges facing Ofgem and the network companies, and the implications of those challenges

Two of the main challenges which Ofgem identifies for network companies are:

- the scale of the government’s targets for a sustainable energy sector;
- the uncertainty about what these targets imply for energy networks.

Ofgem is clearly right to identify both of these issues as being at the heart of what faces network companies and Ofgem itself. To date, Ofgem has also sometimes appeared to use this uncertainty – as illustrated by, for example, the range of possibilities encapsulated by the LENS scenarios – as a reason for not committing to the remuneration of major network spend (in case that spend turns out to be wasted because network requirements turn out differently from what was first expected). In other words, Ofgem seems to be making the default assumption that options and flexibility are maximised by delaying spending decisions.

This is not necessarily the case. Failure to enhance transmission networks in the near future will, for example, reduce the options for major categories of renewable generation in the medium term. This would, in turn, reduce the options for meeting 2020 targets. We note that this has been recognised in the recent report on transmission investment by the Electricity Networks Strategy Group (ENSG), jointly chaired by DECC and Ofgem. This report recognises significant uncertainties about how electricity generation will develop in the UK but also concludes that substantial specified investments will be required to meet 2020 targets.²

The performance of network companies and the RPI – X regime

In the consultation document, Ofgem states that:

¹ Opinion Leader (2009), ‘Ofgem Consumer First Panel, The Future Consumer’.

² Electricity Networks Strategy Group (2009), ‘Our Electricity Transmission Network: A Vision for 2020’.

We have undertaken an assessment of the performance of regulated network energy industries since they were privatised. ... The overriding conclusion of this analysis is that RPI – X has served customers well over the past couple of decades.

The successes of RPI – X are seen as including:

- lower prices for network services;
- increased operating efficiency of network companies;
- higher capital expenditure on networks than in the period before privatisation;
- improved quality of service.

At the same time, Ofgem quotes the ‘consensus view on today’s energy network companies’ as including:

- risk aversion (in their culture and in operational, organisational and financial choices);
- willingness 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;
- greater focus on Ofgem than on their own consumers’ needs;
- reactivity to developments in government policy (whether at national or EU level) rather than proactivity;
- reluctance to innovate;
- focus on their own business but not on interactions with markets or other networks.

At the end of this catalogue of deficiencies, Ofgem asks whether the described behaviour could, to the extent that it is true, itself be a response to the existing regulatory framework and to the incentives which that framework creates.

Ofgem’s whole regulatory philosophy (and that of its predecessor electricity and gas regulators) has been based on the assumption that companies, whether network monopolies or companies operating in more competitive markets, respond to incentives. The outcomes for the electricity and gas industries since privatisation, both *good and bad*, are largely a result of those incentives, many of which have been embedded in RPI – X price controls and associated licence conditions.

Much of the behaviour which is perceived as detrimental by stakeholders has, in reality, been behaviour which has been specifically encouraged by Ofgem. For example, Ofgem has been, over a long period of time, keen to promote the idea that companies should only invest to enhance networks when those enhancements have been underwritten, at least in part, by firm financial commitments from network users. In other words, Ofgem has positively encouraged network companies to be reactive. Only more recently has Ofgem shifted its policy to encouraging networks to *anticipate* future user requirements (through, for example, the Distributed Generation Incentive and the plans for ‘enhanced’ transmission incentives).

Ofgem's attitude to risk and uncertainty

Over the last few years, and including in the current consultation document, Ofgem has criticised network companies for being risk averse – for example, for not undertaking investment unless it has been effectively underwritten by regulator or network users. However, this amounts to little more than a statement that companies will not engage in speculative network development in the absence of a clear framework for rewarding 'successful' speculation (and it is worth noting that Ofgem has premised every network price control, to date, on the basis of network operation being a low-risk activity).

In a competitive market, there are effectively clear rules for providing such rewards (and penalties). The current regulatory regime for energy networks, with minor exceptions (like the Distributed Generation Incentive), provides no such rules. In addition, the tendency for network increments to be added in 'lumps' means that even investments which turn out to be justified in the long term may take some time (and much longer than the remuneration and incentive schemes common in UK utility regulation) to achieve high utilisation of the new capacity.

Put differently, in a regulated environment the reward for taking risks is in the gift of the regulator and the incentives for taking risks will depend, in large part, on the attitude of the regulator itself to risk. The underlying issue is that there are two types of generic mistake which can be made in respect of network investment:

- what could be called 'Type 1' errors, where a network fails to invest in capacity which subsequently turns out to be needed;
- 'Type 2' errors, where a network invests in capacity which subsequently turns out *not* to be needed.

Against the background of its overriding obligations to protect consumers, Ofgem has had (and still has) a relative preoccupation with the risk of Type 2 errors and has sought mechanisms, like user commitment and the financial incentives to under-spend against price control CAPEX allowances, which provide a check on any network's desire to invest ahead of proven existing need.

It is at least arguable that the evolving framework of government energy policy, and particularly the prominence given in that policy to hitting 2020 targets in respect of emissions and renewable energy, may require Ofgem to shift the balance of incentives as between, on the one hand, deferring investment and, on the other hand, just 'getting on with it' – and accept that the latter will increase the risk of stranded assets, a risk which will, at least in part, need to be borne by consumers.

Who decides what networks should be delivering?

Underlying the debate about how RPI – X regulation should adapt from a world of squeezing operating costs to encouraging efficient investment in networks is the question of who or what decides what the networks are meant to be delivering through the capital expenditure in question.

As noted above, Ofgem's preferred model for driving investment to enhance network capability has been to focus on the revealed demands of network users, as manifested by, for example, firm financial commitments from those users. At the same time, Ofgem acknowledges that one of the main challenges which the

regulatory regime needs to confront is the need for a sustainable energy sector where 'sustainability' is, at least in part, defined by government policy and targets.

At times in the past, Ofgem has seemed to assume either that its own statutory obligations did not require it to give great weight to sustainability objectives (relative to its obligations in relation to consumers) or that the revealed demands of network users and the requirements of government policy and targets were compatible – that, for example, subsidies to renewable generators would be sufficient to bring forward the required amount of network user demand for incremental network capacity. Neither of these assumptions would now appear to be valid. The 2008 Energy Act has 'promoted' Ofgem's obligations with respect to sustainability, and it is not obvious that user-led network investment will be adequate to meet government targets for renewable energy.

Against this background, it is not surprising that there have been suggestions of the need for a 'guiding mind' to spell out the high-level outputs that networks are required to deliver.³ The ENA supports this proposal.

The role of energy networks

Closely linked to the issue of the 'guiding mind' is the question of what exactly the *role* of energy network companies is. For example:

- are they meant to be relatively passive *responders* to signals from actual and putative network users (what might be termed 'Model 1', and Ofgem's standard view until very recently)?
- are they meant to be *anticipators* of what those same users will want in the future ('Model 2', reflected in Ofgem's recent proposals for enhancement investment in electricity transmission)?
- are they meant to be responding to some governmental or regulatory 'guiding mind' and, in turn, helping to guide what users will do ('Model 3', and possibly more consistent with the rapid delivery of government energy policy)?

Network companies need clarity on this, and need a regulatory regime consistent with that clarity. In other words:

- Model 1 is consistent with the user commitment model of network enhancement:
 - companies are not assured of earning a full return on enhancement investment unless they have firm financial commitments from network users for the enhancements in question;
- Model 2 would imply more use of mechanisms like the Distributed Generation Incentive and those mechanisms which are envisaged for encouraging electricity transmission licensees to anticipate usage of a much expanded transmission network;
- Model 3 would be more consistent with the traditional RAB/WACC model. In this model, regulatory approval is required for assets to enter the RAB, and that

³ Cambridge Economic Policy Associates (2009), 'A review of the rail and water sector regulatory models, Lessons to learn for the energy sector, A report for Ofgem'. Dieter Helm (2008), 'Credible energy policy: meeting the challenges of security of supply and climate change', Policy Exchange.

approval is, in turn, informed by the high level-network outputs required by the 'guiding mind'.

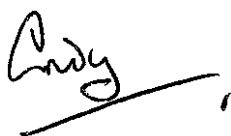
It may be, of course, that different models and regulatory mechanisms are appropriate for different categories of network investment.

In sum, our view is that, amongst other things, the RPI – X@20 review needs to:

- explicitly confront the issues posed by conflicts between government energy policy and what consumers seem to want from the energy sector;
- recognise that uncertainty about the UK's energy future is not in itself necessarily a good reason for not pressing ahead with the development of energy networks;
- accept that both achievements and failings of energy network companies are best explained by the presence or absence of appropriate incentives, rather than any inherent shortcomings in the companies themselves;
- recognise that more risk-taking behaviour by energy networks will require an appropriate willingness on the part of Ofgem to incentivise such behaviour and that this will, in turn, require Ofgem itself to be more prepared to take risks on behalf of consumers;
- design a regulatory regime which is consistent with the desired *role* of energy network companies – specifically, which is consistent with whether companies are required to *respond* to expressed customer requirements, to *anticipate* those requirements or, rather, to provide outputs which are specified by a governmental or regulatory 'guiding mind'.

I hope that these comments are useful. If we can assist in any further way or provide further clarification we would be very happy to do so.

Yours sincerely,

A handwritten signature in black ink that reads "Andy". The signature is written in a cursive style and is underlined with a single horizontal stroke.

Andy Phelps
Director of Policy and Regulation