RPI-X@20 stakeholder workshop – 6 April 2009

Summary of break-out session discussions

What determines the level of network investment and how is it financed?

Introduction

We held an RPI-X@20 industry workshop on both the morning and afternoon of Monday 6 April 2009. The workshops each had 4 breakout sessions focusing on different topics.

The breakout sessions on investment and financing discussed the way energy network investment and utilisation decisions are made. They focused on the key drivers of network investment and examined what influences them along with the implications of alternative models. There was particular focus on the role of Government and the interaction with the regulatory framework. The appropriate regulatory framework for higher risk was discussed along with different models to allow greater return. Finally the impact, if any, of the current economic and financial situation on the regulation of energy networks was considered.

Summary of Morning Break-out Session Discussions

The group started by identifying three possible approaches for energy network investment decision making:

- passive networks; where a network operator's investment decisions follow committed demand from generators or customers and are based on the return available;
- anticipatory networks; where networks' anticipate the need for investments to enhance their networks avoiding parallel changes down the supply chain becoming sequential and producing costly delays;
- network leaders; where networks lead on investment on a 'build it and they will come' model – possibly the only way to make the necessary changes to the network in time to meet the Government's sustainable development outcome targets;

The passive networks model was understood to be dominant at present. In gas and electricity transmission, 50% of the NPV of the total costs of a change of network to facilitate a new connection need to be committed before the transmission network operator will start to build new network.

In gas distribution the situation was identified as simpler given the HSE obligations.

The group recognised that Ofgem had a significant role in determining current network investment. They recognised that Ofgem was generally not comfortable to be the guiding mind and favoured a market solution where possible.

It was noted that there were cost risks associated with the absence of decisions on how investment might be taken forward as well as with the presence of a guiding mind.

The group discussed the need for clarity from Government on what it expected from the energy networks. It was noted that DECC could instruct Ofgem through guidance but that to date it has not used this guidance for that purpose and has failed to commit sufficiently as to what its sustainable development targets mean for the energy industry. Government commitment had also been an issue in other sectors water/rail and in water in England and Wales and recently in Scotland guidance had been sought and given to the respective regulator who then costed the plans.

The group observed that having other agencies influencing the investment decision making, as in water, might be an advantage in creating a useful tension with Ofgem.

Without a guiding mind, the problem was that although Ofgem did not want the role there was no one else. This differed from where investment work in gas was carried out as a response to the HSE.

The group said that it was important to recognise that Government had set a desired outcome through its targets but the issue was how the regulatory regime should work in facilitating the delivery of outputs to produce the outcome.

There was some agreement that Ofgem should go to Government with a proposal for how its outcomes could be delivered through more detailed outputs and get its commitment to them.

The group discussed risky investments identifying size as a critical contributor to the level of risk associated with a project.

The discussion focused on the basis for return where networks take demand risk. Longer control periods (10 – 15 years) were discussed with competition at the supplier level still driving overall benefits while networks had longer to earn returns from investment. It was stressed that it would be important for Government to avoid applying a windfall tax on profits during this longer period.

The group discussed the need for expertise in procurement. This was thought to be unlikely to come from Government and discussion considered an informed consumer or the reporter model used in water and rail.

When considering the impact of the current economic and financial conditions on the long-term framework for energy network regulation, the group discussed whether the continued application of notional gearing might cause problems. In particular, it was important to be clear whether bond holders take pain of difficult financial circumstances. The group noted lessons from the FSA and said it was important to be clear where the risk lies (although noting that the systemic issues in finance are absent in energy).

Summary of Afternoon Break-out Session Discussions

The group noted that much of the regulatory framework relating to investment decisions had been added to the original RPI-X approach. It was also noted that while the RPI-X approach had worked where there was significant ‘fat’ in the industry to cut off, it was a blunt instrument.

There was discussion of how markets determine normal network investment e.g. determining when and where a new housing development is built. This then impacts on the network's investment decision making. Some of the group felt that for normal investment this approach worked with the current regulatory framework. However, the group felt that the Government sustainable development targets produced a different situation that would not be signalled to the network operator through the market.

It was generally recognised that networks could undertake investments with greater risk but only for corresponding higher returns.

The group discussed the information asymmetry problem between regulator and regulated company and particularly how this made the assessment of capital expenditure (capex) allowances difficult for the regulator. It was noted that work had been carried out to improve on this through the fixed capex incentives. However, options such as a rolling 5 year period, or different time horizons for returns on investment were discussed by the group as possible future changes.

The risk averse nature of network operators was highlighted and it was noted that this was what the owners of network operators expected and wanted.

There was a feeling that more guidance was needed from Government about what its outcomes mean for energy networks. The group highlighted the need for the target to be sold by Government as it represents a political decision. However, there was also some concern that this would lead to Government providing 'too much' direction to the industry.

The group was not convinced a regulatory regime could ever be neutral and in particular with generally risk averse network companies.

The group felt that the economic conditions should be returning back to normal at least in a few years and should not therefore be the focus of a review of long run regulation of the energy network. There was a feeling that a deeper charging system might assist in future downturns.