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Dear Hannah,

Working Paper 3 - Regulating energy networks for the future: RPI-X@20, Delivering desired outcomes: Who decides what energy networks of the future look like?

As promised, I attach ENA's response to the paper above sent on behalf of ENA's gas and electricity members.

We look forward to discussing it with you when you come to our meeting next week.

Kind Regards

A handwritten signature in black ink that reads 'Andy' followed by a long horizontal flourish.

Andy Phelps
ENA Director of Regulation

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ENA's Response to Ofgem's Working Paper 3 - Regulating energy networks for the future: RPI-X@20, Delivering desired outcomes: Who decides what energy networks of the future look like?

1. Introduction

Ofgem's third working paper for its RPI – X@20 project is entitled 'Delivering desired outcomes: who decides what energy networks of the future look like?'¹ However, possibly a more accurate description of the substance of the paper is 'Who decides what energy networks of the future will do?'

Ofgem's thesis in this paper can be summarised as follows.

- Ofgem is responding to suggestions of a more prescriptive approach to what energy networks should be delivering by considering three 'models' of who should make the key decisions, albeit that these models 'represent points on a spectrum of options that could be considered', and 'there are a number of different variations in the detail of each of these models'.² The three models are:
 - 'Central Government Led';
 - 'Joint Industry Led';
 - 'Adapted Regulatory Framework'.
- The three models all have certain features in common, including that:
 - the government sets environmental and social objectives;
 - the government determines energy policy;
 - the Secretary of State provides guidance to Ofgem on environmental and social matters;
 - individual networks are responsible for determining their own business plans and for delivering those plans, within the context of their licence obligations;
 - Ofgem is responsible for setting an economic regulatory framework which ensures efficient costing and delivery of those plans.
- Against this common background, the main differentiating factors of the models are that:
 - the Central Government Led model would see central government (or a government agency) specifying, in rather more detail than it currently does, what networks should be doing to facilitate the achievement of environmental, social and security of supply objectives;
 - the Industry Led model would see an industry body (comprising either just energy network companies or wider energy industry membership) providing that detail;
 - the Adapted Regulatory Framework would see the detailed specification of what networks should do arising from networks responding to enhanced incentives to efficiently deliver outputs specified by Ofgem.
- Key points in Ofgem's initial evaluation of the three models are that:
 - the Central Government Led model might be the quickest route to putting in place a plan for meeting environmental targets, but might be expensive, inflexible, not particularly conducive to innovation, and might be over-influenced by short-term political considerations (with the latter feature potentially being mitigated by the lead coming from a government agency, rather than from a government department);

¹ Ofgem (2009), 'Regulating Energy Networks for the Future: RPI – X@20, Working Paper 3, Delivering Desired Outcomes: Who Decides What Energy Networks of the Future Look Like?', July 31st.

² *ibid.*, para. 3.2 for both of these quotes.

- the Joint Industry Led model could improve on the above by better bringing industry knowledge and expertise to the assessment of options for delivering outcomes, but could stifle innovation, not least if the focus was only on network solutions;
- the Adapted Regulatory Framework is ‘potentially the most likely to ensure value for money for existing and future consumers over time’,³ not least, and by implication, through moving more slowly to deciding what needs to be done by energy networks, as well as by utilising a more decentralised model for making these decisions.

Against the above background, this note is structured as follows.

- Section 2 considers some of the core issues raised by Ofgem’s paper.
- Section 3 suggests some tentative conclusions to sit alongside Ofgem’s own tentative conclusions.

2. Issues to be considered in evaluating the Ofgem models

When concluding in favour of the Adapted Regulatory Framework, Ofgem is effectively making judgements in two key dimensions:

- it is making a judgement about the likely trade-off between the government’s *volume* environmental targets and the *cost* of achieving them;
- it is making a judgement about the information which is available about the options for meeting those targets and, specifically, about the uncertainty around those options.

As noted in section 1, Ofgem suggests that ‘the central government model is potentially the one that could put a plan for meeting environmental targets in place most quickly’.⁴ However, the fact that this potential advantage is not decisive for Ofgem seems to be due to at least the following judgements, which Ofgem appears to be making.

- There is significant uncertainty, at least in the longer term, about what options (including what network options) will be most cost-effective in meeting carbon reduction targets—the Central Government Led model will be relatively inflexible in dealing with that uncertainty and with the new information which will become available in time. The Adapted Regulatory Framework would be better at stimulating innovation, learning and adaptation, and would explicitly consider the value of keeping options open.⁵
- A slower but cheaper achievement of government volume targets might be preferable, not least for consumers (and Ofgem’s primary duty is to protect the interests of existing and future consumers).

Each of these judgements gives rise to issues.

Uncertainty and the inflexibility of central planning

One of Ofgem’s themes in its RPI – X@20 presentations and publications has been the considerable uncertainty about what sort of energy networks will be required in the longer term, as illustrated by Ofgem’s LENS scenarios, and Ofgem’s belief that the Central Government Led model, in particular, would find more difficulty in achieving efficient outcomes, in the face of this uncertainty, than the Adapted Regulatory Framework.

The following points could be made about this position.

³ Ofgem (2009), ‘Regulating Energy Networks for the Future: RPI – X@20, Working Paper 3, Delivering Desired Outcomes: Who Decides What Energy Networks of the Future Look Like?’, July 31st, para. 4.3.

⁴ Ofgem (2009), ‘Regulating Energy Networks for the Future: RPI – X@20, Working Paper 3, Delivering Desired Outcomes: Who Decides What Energy Networks of the Future Look Like?’, July 31st, para. 4.3.

⁵ *ibid.*, para. 1.9c.

- Although there is undoubtedly considerable uncertainty about how the electricity and gas sectors will evolve over the next, say, 40 years, there is much less uncertainty about what is required over the next ten years or so. Ofgem recognises this (para. 3.25 of Working Paper 3), particularly in relation to electricity transmission, where the industry-led approach of the Energy Networks Strategy Group (ENSG) has been signed on to by both Ofgem and DECC. However, Ofgem is not clear as to whether this implies that the case for its Adapted Regulatory Framework is stronger in relation to a post-2020 world than it is in relation to delivering what is required in the meantime.
- Although Ofgem accepts that each of its three regulatory models could be subject to significant variation, its argument for the Adapted Regulatory Framework, in which Ofgem is the key government agency, seems to rely heavily, albeit implicitly, on a somewhat Soviet conception of how the Central Government Led model would work—ie, central government specification of what networks will deliver at a quite detailed level.

The following conclusions could be drawn from these points.

- Although there is considerable uncertainty about how networks (and the energy sector more widely) should develop over the longer term in order to facilitate the meeting of government environmental targets, this should not necessarily mean that networks should not be given a clearer steer on what is required in the shorter term. This guidance may well need to go beyond a DPCR5-type requirement on networks to consult with stakeholders, and especially consumers, about what they want. One characteristic of the government’s environmental targets is that, not least because of the costs involved, they go well beyond where energy consumers would seem to want to go.
- The choice of the body that is ‘in charge’ of the process of determining (high- or low-level) network outputs—DECC, Ofgem, a new energy agency—should not necessarily be confused with the process for determining what networks do. The process could involve central planning down to a fine level of detail, or it could involve all of the things to which Ofgem aspires (high-level specification of network outputs, enhanced incentives to deliver those outputs efficiently, appropriate valuation of keeping options open), but there is no unique mapping between points on this spectrum and the organisational framework involved. For example, a process whereby DECC gave rather more useful Environmental and Social Guidance to Ofgem than is currently the case—not least in relation to the government’s trade-off between environmental targets and the cost of meeting them—and in which Ofgem adopted a regulatory framework best suited to delivering on this guidance, would be much closer to what some would see as government playing the role of a guiding mind.

Volume versus cost

It may well be that Ofgem is correct in implying that a slower achievement of government carbon reduction targets would be cheaper for energy consumers in net present value terms, both because of the deferral of spend per se and because time and experimentation may yield cheaper alternatives and less stranded investment. However, even if that were true for consumers, it may not be true for society.

When the government set out its various targets for carbon reduction, including the target of 30–40% of electricity being generated from renewable sources by 2020, it was making a judgement about the value to *society* of carbon reduction on a particular timescale and, by implication, the cost to society of not meeting those targets. For Ofgem to imply that meeting these targets may not be in the best interests of energy *consumers*—because it is likely to be more expensive than a slower carbon reduction—suggests a misalignment between government policy and Ofgem’s duties, which, to date, Environmental and Social Guidance from government to Ofgem has done little to correct. This is not surprising in that the current guidance dates from 2004 (revised

guidance has never progressed beyond 'draft' status), and seems to imply that there is no conflict between hitting (volume) environmental targets and keeping costs down for consumers.⁶

Thus, at least in part, Ofgem's position on meeting carbon targets is broadly the same as the recently stated position of the Financial Services Authority (FSA) on the regulation of bankers' pay, i.e. that regulation to prevent 'excessive' pay to bankers might be desirable from a social policy perspective, but that social policy is for government, rather than for the FSA, and that the FSA is not mandated by government to limit individual pay for social reasons.⁷

In sum, the government's relative emphasis on volume environmental targets, and Ofgem's relative emphasis on the cost of achieving those targets, has been a persistent theme of the last few years. It is likely to be a continuing theme unless government appropriately amends its Environmental and Social Guidance to Ofgem or otherwise amends Ofgem's objectives (beyond the tinkering with those objectives which was a feature of the 2008 Energy Act), or decides that it agrees with Ofgem's implicit position that the cost of hitting those targets is likely to imply the desirability of relaxing those targets. If the government is serious about hitting its environmental targets on the planned timescales, then a more assertive role for government may be desirable—as Working Paper 3 itself implies by identifying the potential for the Central Government Led model to be faster in formulating a plan to achieve environmental targets.

3. Conclusions

Ofgem's tentative conclusions on the guiding mind issue arguably have the following main components:

- government setting objectives only at the highest level;
- Ofgem setting more intermediate objectives and incentivising companies to find innovative ways of meeting them;
- a bias to incremental, rather than 'big' solutions, reflecting its underlying belief that 'big' solutions have a bigger chance of giving rise to stranded investment;
- a bias to just-in-time solutions or, put another way, to delaying decisions on what needs to be done.

What Ofgem's conclusions do not obviously do is respond to what motivates many of those who have advocated the guiding mind approach, ie:

- the perceived overriding importance of hitting the government's environmental targets;
- a view that those targets, especially the relatively short-term ones, will not be met unless there is clearer 'guidance' (from someone) on what is required from energy networks;
- a view that, especially for electricity transmission, there is relatively general acceptance of what is required from networks to meet the relatively short-term targets.

There is thus something of a conflict between those who want to 'just get on with it' (who tend to favour mechanisms which encourage that), and those (like Ofgem) who are more concerned with specifying what 'it' is or, at least, with creating mechanisms which will result in that specification.

On the back of the thoughts discussed in this note, moving towards a resolution of this conflict should probably entail, among other things, the following.

- A clear statement and binding indication from government (whether in revised Environmental and Social Guidance or in the forthcoming Energy Bill) as to what trade-offs Ofgem should be making between facilitation of the achievement of government targets and the cost of achieving them, or, put another way, what trade-offs Ofgem should be making between its duty to customers and its obligation to help achieve government environmental targets.

⁶ Department of Trade and Industry (2004), 'Social and Environmental Guidance to the Gas and Electricity Markets Authority', February.

⁷ Hector Sants, Chief Executive of the Financial Services Authority, speaking on the Radio 4 Today programme, August 13th 2009.

- A clearer recognition from Ofgem than is contained in Working Paper 3 as to (a) what is required of a regulatory regime to facilitate government objectives in the relatively short term, which might well build on the model already provided by the ENSG for electricity transmission, and (b) what might be required to facilitate navigation through the much greater uncertainties which lie well beyond 2020. At present, the RPI – X@20 project seems to be running a significant risk of importing the recognised uncertainties of (b) into the consideration of (a).

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