

## Regulating Energy Networks for the Future: RPI-X@20 Emerging Thinking – A greater role for competition in delivery

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**Target audience:** Consumers and their representatives, those with sustainable development interests, energy transmission and distribution companies, generators and offshore producers, suppliers, shippers, Government, investors, academics and other interested parties.

### Overview:

RPI-X@20 is Ofgem's detailed review of energy network regulation. We are looking to the future on behalf of consumers by considering how best to regulate energy network companies to enable them to meet the challenges and opportunities of delivering a sustainable, low carbon energy sector whilst continuing to facilitate competition in energy supply. There is considerable uncertainty about how best to meet these challenges whilst maintaining value for money for existing and future consumers.

This supporting paper, published in parallel with our main Emerging Thinking consultation paper, provides further detail on the role that competition in delivery could play in the proposed new regulatory framework. We explain why and how we could include competitive tendering in our regulatory toolkit. We also discuss our intention to explore further the potential to make greater use of our ability to revoke licences as a last resort (e.g. by strengthening the Authority's ability to revoke licences for persistent non-delivery) and franchise out some or all of the operations of the licensee. We set out the main issues that we will consider further for our summer 2010 recommendations.

We welcome views on this supporting paper.

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## 1. Introduction

1.1. We think that providing a greater role for competition in the delivery of aspects of network services could help to promote innovation and efficiency in the delivery of network services for current and future consumers.

1.2. In our main Emerging Thinking consultation paper, published in parallel, we suggested that a new regulatory framework could allow a greater role for such competition. That document attempts to provide an accessible overview of our emerging thinking on a potential new regulatory framework and is aimed at a wide range of interested parties. Our ideas on 'embedding financeability in a new regulatory framework' are discussed in more detail in a parallel consultation paper. We will also shortly be publishing a related consultation paper on whether we should introduce a third-party right to challenge to our final price control decisions, as some participants in the review have advocated.

1.3. This is one of a series of technical supporting papers that provide further details on key aspects of a new framework. These supporting papers are aimed primarily at the network companies, investors and other stakeholders who require a more in depth understanding of our thinking and the rationale underpinning it in some or all areas. References for these papers can be found in Appendix 10 of our main Emerging Thinking consultation paper (<http://www.ofgem.gov.uk/Networks/rpix20/publications/CD/Documents1/emerging%20thinking.pdf>).

1.4. In providing a greater role for competition, specifically, we could consider situations where aspects of a company's business plan are tendered out, by the company itself or by Ofgem.

1.5. We do not envisage that tendering required by Ofgem would be the 'norm' or commonplace. Most aspects of network services would be delivered by the existing network companies. However, the potential for elements of a plan to be identified as cases for tendering would need to be sufficiently credible to provide network companies with an incentive to seek out long-term efficient delivery solutions.

1.6. As a backstop, we also intend to explore further the potential for making greater use of our ability to revoke licences as a last resort (e.g. by strengthening the Authority's ability to revoke licences for persistent non-delivery), and the potential role that franchising might play in presenting a way forward in this situation. We will consider this matter further, including associated legal aspects, in developing our summer 2010 recommendations to the Authority.

1.7. This supporting paper sets out, for consultation, further details on our emerging thinking ideas on whether, when and how tendering might be used in the new regulatory framework. This paper builds on analysis presented in our working paper on enhancing competitive pressures on regulated networks<sup>1</sup>. Against a backdrop of

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<sup>1</sup> Regulating energy networks for the future: RPI-X@20; Delivering a sustainable energy sector and value

new challenges and the potential for new innovative technologies to change the scope for effective competition, our working paper explored potential pros and cons of compulsory outsourcing, tendering, and franchising models. It also explored whether networks and existing regulatory frameworks pose any barriers to effective competition in other aspects of the supply chain, informing our proposals focussed on facilitating competition in energy services<sup>2</sup>.

1.8. We have already demonstrated commitment to promoting competition and choice in the building and maintenance of new gas and electricity connections by establishing rights for independent network operators to compete alongside existing distribution network operators in this area. We are considering the relevant lessons from the industry's experience in this area<sup>3</sup>.

1.9. As set out in our working paper, we do not plan, as part of the RPI-X@20 review, to consider further proposals for the development of head-to-head competition between energy networks in supplying network services (transmission and distribution) to network users. Regulation of energy networks will therefore be required for the foreseeable future.

1.10. We do, however, see potential merit in other parties being involved in some aspects of delivery, with the parties potentially being identified through competitive tendering processes. We would need clear evidence that the potential benefits of tendering over the long term would justify the potential costs. When considering benefits and costs we are mindful of the need to consider a range of factors including long-term implications of any decision to tender. For example, we would expect a decision to tender to reflect an assessment of the long-term impact on the cost, safety, security and quality of energy services that existing and future consumers receive and not only on the short-term costs of delivering a specific project. We would need to be certain that a decision to tender rather than deliver through one of the existing network companies would not put at risk delivery of legally binding targets to reduce greenhouse gas emissions or to meet renewables targets. We would also need to be confident that tendering would not raise any significant safety, technical or operating problems.

1.11. We might, for example, consider tendering where evidence emerged that other companies or consortia were able to offer lower costs of capital than those required by the existing network companies. Or we might consider tendering where new technologies are being used for the first time (e.g. high voltage DC cables) and the scope for innovation is arguably greater. But we would not do this if the time required to conduct a tender and then deliver the investment would threaten delivering GB renewable or climate change targets.

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for money: enhancing competitive pressures on regulated networks; Ofgem's current thinking.

<sup>2</sup> Further details on these proposals can be found in our main Emerging Thinking consultation document.

<sup>3</sup> See, for example, section 4 of our RPI-X@20 working paper on enhancing competitive pressures on regulated networks.

1.12. In practice this is likely to mean that tendering would only be considered viable for large projects – for example significant new lines on the transmission system where no existing lines are in place and where the investment is sufficiently large to justify the additional transaction costs of holding a tender. We wouldn't, for example, generally see this as a sensible option for the renewal of assets on an integrated distribution system.

1.13. We will consider the benefits and risks associated with including tendering in the regulatory tool-kit further for our summer 2010 recommendations to the Authority. In particular we are mindful of the need to consider how best to design this aspect of the tool-kit to ensure that it does not result in a framework that is overly complicated or burdensome, and to minimise any potential implications for investor uncertainty.

## 2. Competitive tendering in a new regulatory framework

2.1. In the regulatory framework set out in our emerging thinking consultation document, if implemented, we would have the option to consider whether aspects of delivery should be opened up to competition through the use of tendering. We would consider potential projects by assessing the expected impact of tendering on existing and future consumers, in terms of both implications for timely delivery and for value for money. As noted earlier, by value for money we do not mean a focus on short-term costs but rather an assessment of long-term costs alongside the long-term implications for the safety, security and quality of energy services.

2.2. We expect that the toolkit would apply to all four network sectors, although the scope for tendering to be used may vary over time and by sector. We discuss below when tendering might be most likely to be used. We would expect a review of potential tendering opportunities to be a standard part of future price control reviews, although the number of actual cases where tendering is required by Ofgem are likely to be limited.

2.3. For tendering to provide a real option, projects would need to be sufficiently large to justify the transaction costs, be appropriate from an engineering perspective (for example, with respect to the way in which they mesh with the wider network), and provide opportunities for innovative approaches, for instance in financing and risk transfer, to deliver value to consumers. We would also need evidence that there are companies that are willing and able to deliver the project and that they would be likely to add value in doing so. We expect the majority of outputs to continue to be delivered by the network companies.

### Why introduce tendering into the regulatory toolkit?

2.4. Our thinking is motivated by the potential role tendering could play in delivering our desired outcomes. Tendering could reduce lifetime costs and lead to more innovative, timely, and high quality solutions, both by strengthening incentives on incumbent parties and by facilitating the involvement of third parties in delivery. We see it as complementing our thinking on a package of mechanisms aimed at incentivising efficient longer-term delivery, including new business plan requirements and an innovation stimulus<sup>4</sup>.

2.5. As discussed in the main Emerging Thinking consultation paper, we recognise that there are potential risks with this approach. Most notably, there is a risk that tendering could increase uncertainty for investors and potentially increase the cost of financing. There is also a potential concern that tendering could delay delivery of required outputs or that tendering could result in short-term cost benefits but result in longer-term concerns relating to the reliability and security of energy services (as a whole).

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<sup>4</sup> Further details on these proposals can be found in our main Emerging Thinking consultation document and supporting papers on incentivising efficient longer-term delivery and a specific innovation stimulus.

2.6. As indicated throughout this paper, these risks could potentially be managed through the design of the tendering element of the regulatory toolkit. We will consider further how these potential risks would be best managed for our summer 2010 recommendations, to ensure there is comfort that tendering would help, rather than hinder, delivery of our desired outcomes of the new regulatory framework.

2.7. We will, if we decide to include tendering as part of the regulatory toolkit, work up a set of detailed principles on when and how tendering would be used as part of the regulatory toolkit for our summer 2010 recommendations. The issues that we would need to consider are discussed here.

### **Embedding tendering within the toolkit**

2.8. Bearing this in mind, we have identified a number of ways in which tendering could potentially be embedded within the regulatory toolkit. These are set out below and will be considered further, alongside any others identified, for our summer 2010 proposals. As noted earlier, when considering when and how to include tendering in the regulatory toolkit we are mindful of the need to consider the potential benefits alongside the need to minimise the risk of the framework becoming overly complicated and any potential impact on uncertainty for investors and the regulated network companies.

- Network companies would be expected to provide evidence of their own procurement strategies, demonstrating in their business plans where delivery had been market tested and where outsourcing was expected to deliver innovation and long-term efficiency gains.
- When reviewing network company plans, we may identify potential aspects of the plan where tendering of the build, design and/or operation of the project is considered suitable for tendering, given the nature of the project, and ask the network company to tender out that project themselves. This would be expected to happen on aspects of delivery that are considered to be high cost, with tendering providing a means of testing the reasonableness of the network company's cost forecast.
- When reviewing network company plans, we may identify potential aspects of the plan where tendering of the build, design, operation and ownership of the project is considered suitable for tendering, given the nature of the project. As ownership of assets (by a new licensee – the tender winner) is involved we think it would be appropriate for us to run the tender, building on the approach used for offshore transmission.
- If network companies propose to undertake major projects outside of the timing of the main price control review, that were not discussed at the time of the price control review, there may be an opportunity to consider a role for competitive tendering for these projects.
- If our indicators of output delivery, particularly those related to potential risks to delivery, suggest that there is a risk that a network company will fail to deliver

outputs efficiently and/or on time, we may require the company to tender out delivery, with the expectation that this prospect would in itself incentivise efficient delivery.

2.9. When considering when and how to use tendering in any of these contexts we are mindful of the need to ensure that any potential consequences on company incentives to deliver are managed. In particular, we would need to ensure that the risk of a project being tendered does not cause a company to consider delaying planning or delivery of a necessary project and hence delaying delivery of outputs. We expect our proposed new business planning requirements would go some way in addressing this risk<sup>5</sup>. We would also need to ensure that we do not discriminate unfairly between companies. In limited case where assets might be transferred in the tender, we would consider how to ensure that there is a transparent set of criteria and principles to follow when determining the fair value of any assets being transferred. We will consider the legal aspects of these ideas for our recommendations to the Authority in summer 2010. We will, in particular, explore the potential to require the transfer of assets – in relation to both existing assets and future pre-construction expenditure.

2.10. When considering the detail of our thinking, we will consider further how information from tendering is used to determine the price control. We will also consider any other implications for the wider regulatory framework and for the licensee. Our work for our summer 2010 recommendations will take account of responses to the Emerging Thinking consultation.

### **Circumstances where tendering may be applied**

2.11. We do not envisage setting a single rule (e.g. projects above a particular size) to identify when tendering would be used. Potential projects would be assessed on their own merits. As noted in Chapter 1, we expect that at price reviews we would actively consider whether there is a case for using the tendering element of the regulatory toolkit but in practice the number of projects where Ofgem requires a company to tender out a project, or where Ofgem tenders a project itself, would be limited. For example, investments in new large-scale gas transmission projects that are separable from the rest of the network might be considered. On the other hand, large projects (in monetary terms) that involve assets meshed in an existing electricity distribution network are unlikely to be considered.

2.12. We recognise concerns that tendering could introduce uncertainty of regulatory treatment of investment, for investors undertaking risk assessments and for network companies considering investment proposals. We would establish published guidelines incorporating a set of principles on the type of projects that are most likely to be considered for tendering to help manage any uncertainty. The aim would be to manage the risk of uncertainty with the need to ensure that tendering as part

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<sup>5</sup> Further details on these proposals can be found in our main Emerging Thinking consultation document and our supporting paper on incentivising efficient longer-term delivery of desired outcomes.



of the regulatory toolkit is considered credible by network companies to encourage them to seek out efficient delivery solutions themselves.

2.13. Along with other issues, the guidelines on the type of projects that would be considered are likely to cover:

- the scale of the project,
- the extent to which the project is separable from other network activities,
- the timing of delivery of associated outcomes,
- the extent to which work has already started on a project and where logical break points lie, and
- the extent to which there is concern about the efficiency of the network company's proposed or forecast costs.

2.14. We would take a balanced approach to assessing these characteristics. The relevant importance of these characteristics would depend in part on the design of the tender process. For example, if the tender is to design and build assets the importance of a project being separable may be less of an issue.

2.15. We would consider whether tendering would be expected to deliver information on the scope for efficiencies and innovation, either through the bidding process or through broadening opportunities for comparative benchmarking. We would also consider any opportunities tendering might present to mitigate against risks borne by consumers, for instance in the event of cost overruns, or to diversify any risks which may impact on timeliness and quality of delivery. We would take account of the administrative and potential implementation costs of the tender process and costs associated with any potential delays associated with tendering.

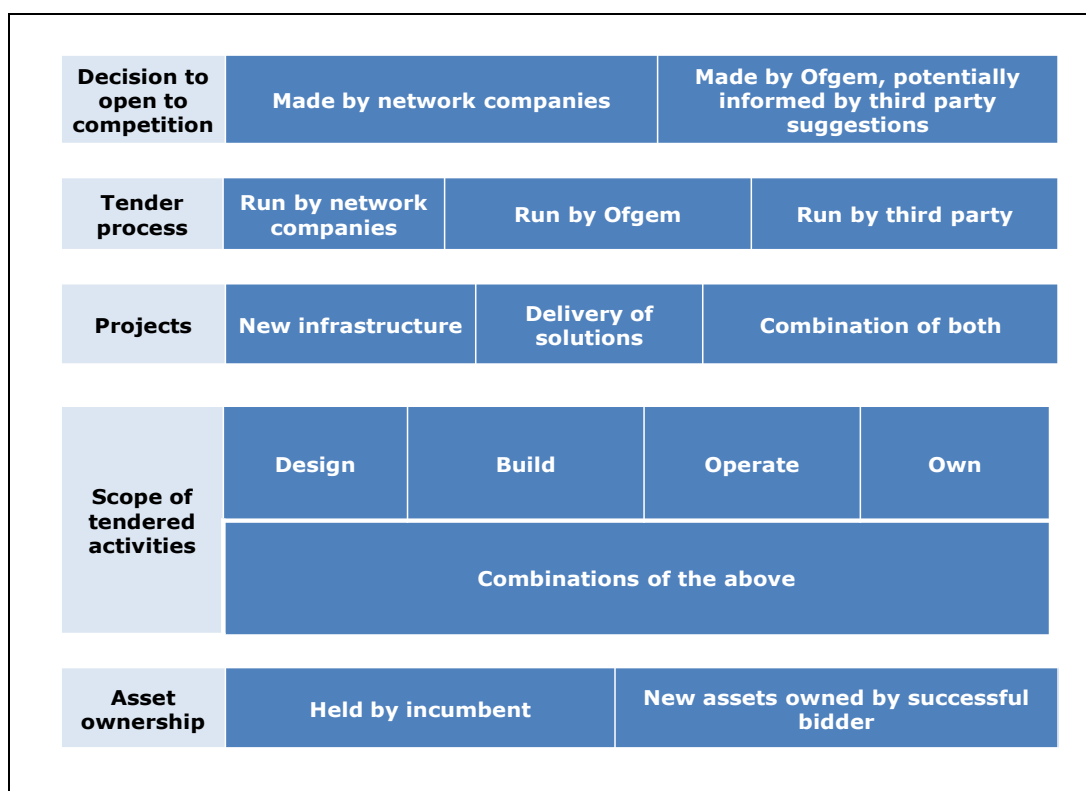
2.16. Consistent with the wider regulatory framework, the overriding focus would be on ensuring that tendering would be expected to deliver benefit for existing and future consumers for the long term. We would also consider further the interactions between tendering and wider incentives to encourage efficient long-term delivery.

## **Tender design**

2.17. The design of the tender has a direct impact on the potential benefits for existing and future consumers and hence on the justification for the tendering of a particular project. We do not envisage a 'one size fits all' approach to tender design; the appropriate design would depend on the scale and nature of the project being delivered and on the time constraints on the length of the tender period to ensure delivery is not jeopardised. Potential increases in administrative costs, offset by any opportunities tendering may present to lower these costs, would also need to be taken into account when considering appropriate tender design.

2.18. The tender guidelines that would be published would set out tender design options and provide a view on the circumstances in which different designs might be appropriate. Each case would need to be considered on its own merit, with scope to vary different aspects of the design and to adapt and learn over time. We set out in Figure 1 below the spectrum of options simplified for illustrative purposes that we will be exploring further. We welcome views on whether there are other aspects of tender design that we need to consider for our summer 2010 recommendations.

**Figure 1 – Spectrum of potential options for tender design**



2.19. In addition to these features, we would need to consider who would be eligible to bid, recognising that policy thresholds such as licence conditions may pose some constraints. We are mindful of the need to consider implications of the EU third package and other legislation when looking further at this issue.

2.20. We discuss each of these aspects, in turn, below:

- **Who decides whether delivery should be opened up to competition?** In some cases the network company would decide themselves, as part of their efficient procurement strategy, to open delivery up to competition. In other cases we would decide, potentially informed by suggestions arising in our engagement with third parties.

- **Who runs the tender?** We anticipate that – as already happens - in many cases tenders would be run by the network companies themselves, with Ofgem looking for evidence of efficient procurement as part of the assessment of the company's business plan. For some projects, where assets are to be owned by the tender winner (a new licensee), Ofgem may run the tender, building on the approach used for offshore transmission. We may choose to use an independent panel to run those tenders.
- **What is being tendered?** A third party could be involved with the design, build, operation and/or ownership of particular projects or assets. This might include designing non-infrastructure solutions. The tender could be for any combination of these activities; for example, the design and build of a project could be tendered out with the network company remaining responsible for operation or ownership. Alternatively, similar to the offshore tender regime<sup>6</sup>, the tender could be for a third party to design, build, operate and own the project and assets. We expect that the appropriateness of design will be dictated by where the benefits of third party involvement are expected to be greatest, which option is most likely to result in timely delivery of outcomes, and by feasibility given other aspects of the price control framework. In some cases, the contract awarded through the tender process might lead to the development of new energy network assets. Part of the tender design would then involve determining whether these network assets would be owned and subsequently operated by the incumbent network company, or by the successful bidder. There might even be circumstances in which a tender process could involve the transfer of assets from the incumbent to the successful bidder (subject to safeguards on appropriate valuations for the transferred assets).
- **Who can bid?** At the start of any tender, the party running the tender would need to set out details of who is eligible to bid. There may even be a formal pre-qualification stage to the tender, requiring potential bidders to demonstrate that they meet specified requirements. A key issue to decide is whether the incumbent network company can bid itself. We would also consider further whether bidders need to be licence holders and, if they do, what nature of licence they would need to hold.

2.21. We will consider these and other aspects of design for our summer 2010 recommendations. We will also consider any legal issues, including any implications of the third package of legislation on the internal gas and electricity markets, other relevant legislation, and the progress of proposed changes to the Authority's duties under the fifth session Energy Bill.

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<sup>6</sup> A regulatory regime that will see companies competing for the award of transmission licences to build, own, and maintain offshore transmission assets through a competitive tender process. Further details can be found at the following link:

<http://www.ofgem.gov.uk/Networks/offtrans/Pages/Offshoretransmission.aspx>

## **Licence revocation and franchising**

2.22. We do not plan to develop proposals for the franchising of large areas of network operations. We do intend, however, to explore for our summer 2010 recommendations the potential to make greater use of our ability to revoke network licences as a last resort (e.g. by strengthening the Authority's ability to revoke licences for persistent non-delivery), with a view to franchising out some or all of the operations of the licensee. We will work up the detail of how proposals on licence revocation might work in practice over coming months, recognising that to a large extent the practicality of this option will depend on legal constraints.

### 3. Next steps

3.1. If we decide to include tendering as part of the regulatory toolkit, we will focus on developing guidelines for how and when tendering might be used for our summer 2010 recommendations.

3.2. As we indicate above, we recognise that tendering within the sector may change perceptions of risk and could introduce uncertainty as to regulatory treatment of investment. We see this as underlining the importance of clarity and transparency of these guidelines. We would also explore how these considerations could be embedded within evaluation criteria.

3.3. When considering the detail of how tendering might sit in the regulatory framework we will, in particular, consider potential legal issues associated with any proposals.

3.4. In the meantime, we invite views on the issues explored in this paper.