RPI-X@20 – Emerging Thinking

Summary of issues discussed at our academic workshop

23 March 2010

Ofgem Offices, 9 Millbank, London

Introduction and objectives of session

The day was split into four sessions:

1. Innovation and the delivery of a low carbon energy sector
2. Focus on the needs of consumers and other stakeholders
3. Competition in delivery
4. Long term efficiency incentives

The workshop began with a short introduction. The inclusion of many ideas generated or discussed at the previous academic workshops was welcomed, and the key purposes for the day's discussion were presented:

- Setting the proposals in the context of an academic framework;
- Highlighting areas where evidence was insufficiently used;
- Considering how the proposals promote sustainability; and
- Providing a challenging radical viewpoint.

An issue raised was the need for consistent accounting treatments for the network companies. Specifically, what progress has there been in achieving such consistency? Work has been carried out in this area and is done incrementally at each review with progress being made, but there is more work to do.

It was also argued that clearer principles would be needed for economic asset lives, and it was suggested that this is actually an accounting problem. It was also suggested that better "output accounting" may be needed. It was concluded that proper measurement should be core to regulation.

Overview of RPI-X@20 Emerging Thinking

Cloda Jenkins (Ofgem) provided an overview presentation of Emerging Thinking.

The new regulatory framework will encourage innovation on energy networks and will encourage delivery of a sectoral solution to the delivery of a low carbon economy.

Iain Morgan (Ofgem) gave a brief introductory presentation.

Robert Sansom responded.

It was generally agreed amongst the group that there is limited incentive for the network companies to take risks unless a sufficient reward is available, and that companies will not generally innovate for innovation's sake. A suggestion was made that Ofgem develop a 'single vision' for the networks.

The group discussed complexity in evolving networks, and the pressure it places on the skills within the network company. It was agreed that the networks may not innovate, but that this function cannot be based within Ofgem either. It was suggested that a separate organisation made up of a group of experts is needed to question the networks on why they aren't investing in particular innovations. The group debated whether the example of Spain where technical specialists in a separate organisation from the network companies or the regulatory body might be the right source of this expertise within the UK model. One delegate said that new entrants have to be introduced in order to incentivise the incumbents to change behaviour. The group discussed the separate 'system planner' model in Victoria, Australia.

It was suggested that a separated independent SO might play this "challenge" role if it is not responsible for investments. A delegate asked whether the TO/SO structure in GB could be improved.

No consensus was reached but it was agreed that this was an area that Ofgem should consider further.

There was support for a decentralised structure being more appropriate, highlighting that if Ofgem incentivise the networks to do something, it will be done. One delegate highlighted Ofgem's LENS project which illustrates the significant range of different ways the networks could evolve. It was emphasised that a decentralised solution would only work if there was clarity on what networks were expected to deliver.

It was suggested that National Grid should be developing innovative charging structures e.g. a nodal price system, but because there is political pressure to overcome and effort required to do it, a reward might be needed to get this to happen.

The group emphasised the need to consider the risks of a failed investment, and whether Ofgem should have responsibility for signing off innovative investments. Cost recovery and incentives to innovate would then depend on the soundness of a risky investment decision, rather than on its outturn. One delegate highlighted that specific innovation funds are only useful for minor improvements and large-scale 'disruptive technology' (which is the case re some of the changes in energy networks) needed something else – the required innovation might largely be outside the networks control. The discussion examined the pros and cons of this argument, with some delegates suggesting that the networks will need to change in terms of their engineering capabilities.

The new regulatory framework will ensure that energy networks and Ofgem focus on the needs of consumers and other stakeholders.

Cloda Jenkins gave a brief introductory presentation.

Jon Stern responded.

Jon Stern's presentation outlined the following:

- The outputs/outcomes are too numerous and too vague;
- The boundaries between policy and regulation were clearly changing with a greater role for policy;
- Ofgem could become the procurer for network companies rather than the regulator;
- Are Government policy targets binding? And how do they get revised or dropped?
- Why is Ofgem moving to a quasi-procurement model?
- More clarity on Ofgem objectives is needed;
- More transparency is needed on policy – what incentives are there for government to do this?
- How do Ofgem intend to deal with a breach of promise?
- What is Ofgem's position if there is no common understanding between Government, regulator and companies?

RPI-X@20's two intended outcomes: (a) networks contribution to the delivery of a sustainable energy sector; and (b) value for money for consumers were discussed. The group asked what would happen if sustainability targets proved to be unattainable, and it was agreed that "stages" of innovation and "exit routes" could be provided for the companies, if this proved to be the case. It was agreed that, following consultation, Ofgem should be the body to decide how much companies would need to pay for these exit routes as this was a question of option values.

The group then discussed whether there was an incentive for any parties to find information on the least cost location of offshore wind farms, and it was suggested that Ofgem had a role in supporting this.

It was suggested that external stakeholders should have a part to play in deciding upon investments. However, some believed that there are too few parties both willing and able to engage and that efficient decisions are not guaranteed if not all interested parties are involved.

Comparisons were made to the issues looked at in the Cave review in water, and options for changing incentives from favouring capex in all cases:

i.) Enhanced review - but there are problems with information asymmetry;

ii.) Central planning/single buyer – but this is difficult to implement and has major disadvantages; and
iii.) Bilateral trading – difficult and would only be practicable for water while maintaining household monopoly franchise.

The new regulatory framework will encourage competition in delivery, ensuring innovation, value for money and facilitating energy service companies.

Cloda Jenkins gave a brief introductory presentation.

Chris Bolt responded, including a discussion of his experience from the London Underground PPP contracts as a relevant example. The presentation highlighted the following:

- Competition in delivery may lead to incompatible networks or incompatible elements;
- How do we ensure that those who fail to deliver suffer the consequences?
- Determining whether the companies have delivered efficiently is extremely difficult even well after the event; and
- Assessing the appropriateness of procurement decisions is extremely resource intensive – and who bears the risk of the regulator's judgement being worse than a network company's proposal?

There was debate as to the value of tendering. With arguments put forward to suggest it is only successful in certain conditions. One delegate pointed out the case of Ofgem's offshore transmission tender, deemed to be successful in attracting new bidders. However, others specified that whilst tendering may minimise immediate costs of procuring equipment, it does not work for long-term franchises in regulated industries, due to the need to adjust for changing circumstances, and that the empirical evidence is mixed. Concerns were also raised about potential micromanagement.

It was also noted that if new delivery solutions were being considered, that the incumbents have not done before, it shouldn't be presumed that they are the best to deliver these solutions.

It was highlighted that Energy Service Companies (ESCOs) could prove advantageous as they encourage new people, and therefore, new thinking. Ofgem had a duty to ensure that current regulation did not preclude them as they were a part of a potential low carbon future. And it was also suggested that the threat of bypass would incentivise the energy networks and force an incumbent to open their network to third parties. However, some members of the group warned that by-pass could be uneconomic and might only create new incumbents subject to the same problems as existing incumbents.

Some debate took place as to whether small companies or large companies would be more competent at innovating, with the conclusion being that it would be important to find the "least bad" way. The group then discussed whether the DNOs are appropriately set up to aid this transition.

The new regulatory framework will provide strong and targeted efficiency incentives on network companies for the long term.

Iain Morgan gave a brief introductory presentation.

Graham Shuttleworth responded.

His response highlighted the need for a stable and transparent regulatory framework. He identified some imprecision in the drafting of the Emerging Thinking consultation which may lessen the stability and transparency of the final framework, in particular:

- 'Multiple' objectives are involved without clarity of the weightings assumed;
- Undefined use of 'proportionate', 'targeted' and 'appropriate' (need more detail as to what this means in practice);
- 'Partial' longer term price control – not clear that this will provide longer term certainty if combined with an overall review of "the package";
- Adaptation – flexible but not clear what basis for change would be and how it would be reconciled with stable (time-consistent) long-term incentives;
- References to "reputation" for delivery and "deemed" efficiency suggested subjective judgement.

It was highlighted that the environmental issues introduce further uncertainty and that monitoring is needed to ensure outputs are delivered. The role and usefulness of benchmarking was discussed.

The workshop ended with a discussion around Ofgem's suggested less resource intensive price controls for the network companies who have a good record with the regulator. There was some concern that this would rely heavily on subjective judgement but others agreed that this idea seemed sensible and more proportionate.

Ofgem emphasised that the vision was to develop a framework where there was more transparency around a defined agreement, with long term commitment where possible. It was noted that this needed to be emphasised and made more clear in the RPI-X@20 recommendations documents to ensure everyone had a clear and common understanding of any new framework.