

# IAM Public Statement

## Response to Ofgem Consultation by invitation dated 2 March 2010

(First published by Ofgem: 20 January 2010)



## Regulating Energy Networks for the Future: RPI-X@20

### Emerging Thinking – Embedding financeability in a new regulatory framework

#### Background

1. The Office of Gas and Electricity Markets (Ofgem) is undertaking a detailed review of energy network regulation, its RPI-X@20 project. Ofgem is 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.

2. Ofgem has published a paper 'Emerging thinking – Embedding financeability in a new regulatory framework' to provide a straw man proposal on how Ofgem could embed its financing duty in the new regulatory framework. The paper focuses at a high level on: what Ofgem means by financeability; the issues raised by the current assessment of it; and a set of principles for embedding financeability into the regulatory framework. This has been published in parallel with Ofgem's main Emerging Thinking consultation paper.

3. Scott Phillips, Manager, Regulatory Finance, RPI - X @ 20 and Regulatory Finance, has invited the IAM to comment on the financeability paper as part of their preparations to make recommendations to the Gas and Electricity Markets Authority (GEMA) in summer 2010.

4. The IAM is the professional body for the optimal lifecycle management of physical assets to sustainably achieve the stated business objectives and the IAM has a key objective of promoting good practice in infrastructure asset management. The IAM's Council has explicitly recognised the importance of engaging with the finance and accounting community to better enable whole life, cost / performance / risk optimised management of critical infrastructure and we are, therefore, delighted to contribute to this Consultation.

#### Summary

5. Much of the emerging thinking is still at the high level principles stage. There is not yet much detail as to how the propositions would work in practice and so these comments are based on our understanding of intent.

6. The IAM welcomes the following potential improvements to energy regulation:

- a) Recognition that 'value for money' for existing and future consumers requires network companies to seek out innovative, efficient and effective long-term delivery solutions, which are not necessarily those that are cheapest in the short-term, particularly when considering risk mitigation;

- b) Developing regulatory support for the provision of a low carbon energy sector;
  - c) The proposal to lengthen the price control period in some areas, allowing networks to commit to an approach from one review period to the next. This reflects the fact that sustainable management of assets with lives that span decades has to focus on longer timeframes than the traditional five-year window. However, there will be a need to balance this with the flexibility required to react to new knowledge and deliver a low carbon energy sector;
  - d) Recognition that trial and error, adaptability and consideration of a much wider range of potential delivery options than has been the case historically will be needed; these advances will need the support of a specific innovation stimulus.
7. As an independent organisation for professionals dedicated to furthering understanding of asset management, the IAM is convinced of the benefits of sharing knowledge and experience across sectors (including energy, water and transport).
8. The IAM has concerns around the following areas of emerging thinking and would wish to understand the proposals in more detail:
- a) The use of the word ‘sustainable’ in these documents appears to refer to ‘low carbon’. For example, the term ‘sustainable energy sector’ is used to describe the changes needed to facilitate the legally-binding EU targets for renewable energy. IAM would prefer to see ‘sustainable’ used in its wider meaning. An appropriate definition is contained in the BSI PAS 55:2008 standard for asset management. This defines ‘sustainable’ as “*achieving or retaining an optimum compromise between performance, costs and risks over the asset’s life cycle, whilst avoiding adverse long term impacts to the organisation from short-term decisions*”. This more inclusive definition is particularly relevant to the financeability discussion.
  - b) Although ‘intangibles’ are important, regulatory processes need to be incontrovertibly fair and objective to allow regulated companies to operate with confidence. The IAM would have concerns about suggestions that treatment will be based on subjective matters (eg, the level of regulatory scrutiny would depend on the “company’s reputation for efficient delivery<sup>1</sup>”). Intangibles such as reputation should be defined by objective measures;
  - c) The use of output measures to judge outcomes, which, while attractive as an economic model, is very difficult to get right in practice for a network business. The wrong choice of output could have unforeseen and unintended impacts on a business. This is not a reason for lack of action in this area; it is instead a note that the development of a complete set of output measures may prove challenging.

## Declaration of Interests

9. The IAM’s reviewers of the Ofgem consultation included some Members working in the sector. Whilst our Public Statement has been peer-reviewed, our reliance on this expertise and experience is declared publicly for the avoidance of doubt.

10. This Public Statement has been drafted according to Council’s formal Procedure and this final version has been released as the collective view of the IAM.

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<sup>1</sup> Regulating energy networks for the future: RPI-X@20 Emerging Thinking Para 4.19

## **The IAM's Observations and Comments**

11. The IAM's responses below are general observations on the principles discussed in the consultation rather than comments addressing specific financial or technical issues.

### **Long-term value for money**

12. The Emerging Thinking consultation recognises that 'value for money' for existing and future consumers requires network companies to seek out innovative, efficient and effective long-term delivery solutions, which are not necessarily those that are cheapest in the short-term. Ofgem therefore propose to ensure value for money by providing network companies with a package of incentives to look for the likely lowest total cost solutions over the long term.

13. The IAM notes that this long-term approach appears to match the BSI PAS 55:2008 framework, which describes the need for jointly optimised and prioritised risk-based asset management plans to achieve an organisation's asset management strategy and deliver asset management objectives across the life cycle. Life cycle stages identified for consideration in the PAS55 framework include:

- a) Creation, acquisition or enhancement of assets;
- b) Utilisation of assets;
- c) Maintenance of assets;
- d) Decommissioning and/or disposal of assets.

14. In assessing whether the cost levels associated with delivery represent value for money over the long term, Ofgem envisage using a mix of techniques, including total cost benchmarking, expert assessment of network company plans and engineering models, and analysis of network companies' own benchmarking analysis and productivity assumptions.

15. The IAM recognises that a cross-disciplinary, whole life cycle view of asset management yields significant tangible and sustainable benefits. The IAM therefore supports and encourages the proposed approach.

16. The IAM agrees that the incentives framework should be focused on delivery of outputs, not delivery of the business plan. The latter approach could stifle innovation and the natural evolution of business plans as external drivers change and knowledge improves (eg asset management knowledge around existing assets, or forecasts of future generation and demand patterns). However, the selection of appropriate outputs will require considerable effort, especially as the links between actions, output measure changes and desired outcomes may show considerable time lags.

### **Facilitating a low carbon energy sector**

17. The IAM supports Ofgem's statement that they want energy network companies to look to the future, anticipating what is needed to facilitate the delivery of a sustainable energy sector. The classic dilemma with all infrastructure networks is stakeholder pressure to provide access to the services afforded by the infrastructure 'in advance of need', with issues such as high speed rail and universal broadband in the current headlines. Financing should facilitate prudent provision to prepare for future extension or enhancement, whether through additional physical assets or through 'future proofing' new assets.

18. The IAM recognises that the facilitation of a low carbon energy sector contains many uncertainties concerning the requirements and technologies that will be needed. As Ofgem notes, this leads to uncertainty about the useful life of any assets installed in support of low carbon technology. The IAM agrees that this may therefore require taking some risk with consumer money by potentially providing early funding for network plans based on anticipated future requirements.

### **Partial lengthening of the price control period**

19. For energy networks, where the majority of assets have technical lives that span decades, anything that incentivises long-term decision-making should be an improvement. Lengthening the price control period for aspects that are relatively certain and stable should allow companies to make better long-term decisions.

20. However, given the simple fact that plans become inherently less definite over time, coupled with the current uncertainty around investment required for a low carbon energy sector and gas supply volatility, flexibility will also be key. It would be unrealistic to expect network companies to have an assured view of the next ten years and Ofgem should recognise that maturation and evolution of plans should be expected and welcomed.

21. Infrastructure must be managed and operated against a long-term framework of sustainable objectives, but it may be that a shorter term view is necessary for proper short-term governance. The IAM would therefore recommend that any long-term framework should be actively supported through a process of objective short term reviews.

### **Innovation**

*Ofgem asked: "Do you have comments on the design of a cross-sectoral time-limited innovation stimulus that is open to a range of parties?"*

22. The IAM welcomes the specific innovation stimulus and the introduction of the Low Carbon Network Fund during the latest electricity distribution price review. The IAM agrees that, in some cases, the benefits from innovation will accrue to the wider world (for example, in the case of some low carbon network enabling technologies). However, reliance on market forces alone may not provide the required impetus, especially in a regulated environment. Specific stimulus measures are therefore an appropriate and effective way to provide short-term direction and focus to areas that require urgent innovation.

*Ofgem asked: "Do you agree that it is appropriate to encourage network companies to work with others to identify cross-sectoral solutions to the challenges the sector faces?"*

23. As an independent cross-sector organisation, the IAM provides a forum in which we see the benefits of this sort of engagement with asset owners and service providers in all other sectors – and we can report active exchanges between, and work done by, Members in energy, water and transport. This activity is building on the generic infrastructure view which started with the creation of PAS55 and it is providing very useful insight into the commonality of many of the challenges faced by infrastructure operators, whether in the UK or elsewhere. The IAM strongly agrees that cross-sector solutions should make a significant contribution.

24. The IAM led the development of PAS55 as a cross-sector standard for asset management and it has also developed products to support and disseminate asset management good practice, in particular, the PAS55 Assessment Methodology (PAM) and the Competences Framework (CF). PAM is a tool that enables both self-assessment as well as 3<sup>rd</sup> party assessment (whether or not leading to certification)

of the extent of compliance with BSI PAS 55:2008. The CF is freely available to enable the recognition of Asset Management competence and also the creation of relevant qualifications and training that dovetail with other management frameworks.

25. The IAM's attention is now focused on maturity assessment and excellence of performance 'Beyond PAS55 Compliance' in one or more characteristics. The IAM is also collating and recognising sector-specific good practice (and developing it where it does not exist). The IAM is already producing draft Sector Specific Guidelines, the first of which is about managing Asset Information. It is expected that these and other developments will be useful in support of cross-sector benchmarking.

26. The use of PAS55 in more or less formal terms is playing an explicit part in good practice regulation in many different countries and the IAM would be interested in supporting the development of good practice guidelines for regulation across all sectors.

27. Most immediately, the IAM has initiated an ISO project (through BSI) to develop an international standard for asset management. The context to all of this work is the encouragement of global convergence and the IAM is collaborating with many groups worldwide to incorporate best practice from the standards in other countries.

### **Sustainability**

28. The use of the word 'sustainable' in these documents appears to refer to 'low carbon'; for example, the term 'sustainable energy sector' is used to describe the changes needed to facilitate the legally-binding EU targets for renewable energy. IAM would prefer to see 'sustainable' used in its wider meaning.

29. The IAM recommends the use of the PAS55 definition of 'sustainable' as "*achieving or retaining an optimum compromise between performance, costs and risks over the asset's life cycle, whilst avoiding adverse long term impacts to the organisation from short-term decisions*". This viewpoint is particularly relevant to the financeability discussion.

### **Proportionate and differential treatment of networks**

30. The consultation proposes the concept of proportionate regulation, whereby the level of scrutiny and approach of the Regulator in the price control process will be dependent on (among other things) the track record for delivery of network companies. There are a number of important areas where a company's reputation for efficient delivery is proposed to be used as a measure; these include: the range of areas over which longer price controls are judged to be appropriate; the level of scrutiny of business plans; variations in incentive rates between companies and Rate of Return on Equity (RoRE). It is therefore essential that the methods used to determine the 'reputation' of an organisation are objective and transparent.

31. It is right that the regulatory assessment of infrastructure companies should be based on the quality of their planning and the delivery of their outputs. Ofgem acknowledge that, "Our approach would need to be transparent and credible. We would also need to ensure that our approach is non-discriminatory." Given that the performance of our regulated infrastructure organisations is both experienced and judged by a wide spectrum of expert and lay audiences, the Regulator should provide rational evidence-based assessments of the robustness of industry processes and performance and intangibles (using evidence from stakeholders) rather than use judgement or perception.

## Output measures

32. The IAM supports the introduction of output measures in the DPCR (Distribution Price Control Review) and notes that there is extensive work still to be done on a cross-sectoral front to develop robust and comprehensive output measures before they can be regarded as good indicators of the present and forecast performance of large and complex infrastructures, particularly when the consequences of investment may take time to be realised.

33. The IAM would urge companies, regulators and stakeholders to work together to develop longer-term targets and forecasting methodologies in line with the wider objectives which are being set. This is essential given the demand for change in the energy sector. This will not be an easy process; national infrastructures affect society as a whole and there will be conflicting stakeholder interests. There will also be the challenge of engaging in the debate around what the next generation of customers may require.

## Conclusion

34. The IAM supports many of the proposed progressions to network regulation contained in Ofgem's Emerging Thinking consultation. In particular, the IAM would welcome wider definitions of value-for-money (not just lowest delivery cost), the facilitation of a low carbon energy sector, longer-term regulatory commitment in areas where there is relative certainty and an extension of the existing innovation stimuli (and the widening of these to non-network companies).

35. The IAM has some remaining doubts about the definition of 'sustainable' as used by Ofgem, the potential introduction of subjective (differential) regulation based on the assessment of intangible measures and the difficulty of introducing robust output measures for complex network outcomes (particularly due to the complex linkages and the time delay between cause and effect). The IAM feels that it is not appropriate to be more definitive in these areas until the thinking is set out in more detail or is developed further.

36. The IAM welcomes the innovative and forward-thinking nature of this consultation and looks forward to further opportunities to contribute to the RPI-X@20 project.

Issued by the Institute of Asset Management on 8<sup>th</sup> April 2010

In the event of the need for any further information or comment, please contact

The Secretary  
Institute of Asset Management  
St Brandon's House  
29 Great George Street  
BRISTOL  
BS1 5QT

08 454 560 565  
[www.theIAM.org](http://www.theIAM.org)  
[CEO@theIAM.org](mailto:CEO@theIAM.org)