

The Beesley Lectures

Response by David Gray to the lecture presented by Hannah Nixon

How can network regulation be designed for industries undergoing transformation?

First of all, I would like to thank Hannah, and congratulate her, both for that very interesting lecture and for her role in the development of energy network regulation through the RPI-X @ 20 review and the development of RIIO.

In responding to Hannah's lecture I want to do three things.

First, reinforce the points she made about how RIIO was designed to deal with a changing and more uncertain environment.

Second, provide an update on how RIIO is working out in practice, including a few words on the results of the appeal which was published earlier this week.

And then I'd like to move beyond network price controls and say a few words on how Ofgem is thinking more generally about regulating for an uncertain future.

The Design of RIIO

Hannah has described the thinking behind the development of RIIO so I won't labour the point but, to me, the main features of the new approach are:

- first, the requirement for companies to engage with stakeholders and get some real input on what consumers and users of the network want.
- linked to this, a clear statement of the outputs that we and other stakeholders can expect on the basis of the price control allowances.
- the 8 year review period which was intended to encourage longer term thinking but should also have the valuable effect of providing a more stable business flow for the supply chain
- the increasing use of mechanisms to deal with uncertainty - re-openers and volume drivers to deal with the more unpredictable items and the mid-period review to deal with any changes to the required outputs.
Some of these can be quite large. For example, earlier this year under the Strategic Wider Works process we agreed an additional allowance of over £1 billion for SSE to construct the Caithness – Moray transmission link and, just recently, we used the re-opener for site security costs to allow expenditure of several hundred million pounds in this area.
- the use of totex allowances – rather than capex and opex separately – trying to remove any unintended bias towards capital solutions.
- and, finally, measures to encourage innovation which could potentially provide as much as £1 billion for research and trials during the first round of RIIO price controls.

The underlying message – to repeat something I used to say *ad nauseam* when I was doing price controls myself – is that it's not our job to run the industry. The onus should be on the companies to produce good business plans designed to provide the right outcomes for their customers and other stakeholders as well as their shareholders – with the minimum of distortion from the regulatory regime.

Update on the first round of RIIO controls

So how's it working out in practice?

The first thing that struck me – when I came back to all this during the ED1 price control process – was the real improvement in the quality of the business plans. The best ones do actually look like a plan for a business – rather than the rather “blunt instrument” style of negotiating position we used to receive.

Another is the continuing improvement in customer service. Network companies are delivering better reliability and better, more rapid, response to problems when they arise. I've been particularly intrigued to see one of the GDNs, Northern Gas Networks, winning awards for customer service (not just in the utility sector but against consumer-focussed companies across the full range of the economy). Indeed a number of the network companies are getting scores for customer satisfaction that put them at the top of the league table across sectors while some of the big energy suppliers, which you might expect to have more of a focus on customers, are at the bottom of the league.

Of course, not everyone sees network regulation in a positive light. One thing that politicians and others have picked up on, and keep returning to, is the fact that the companies are all earning high returns – and are expecting to maintain that over the whole of the 8-year period.

The question that follows is whether that is what we would expect to see – that is, the incentives doing their job – or a failure of the approach, reflecting continuing information asymmetry?

We've always said that we would expect higher returns for top performing companies and, as I said, performance standards and customer service have improved significantly.

There are also signs that the 8-year price control period is allowing companies to undertake more substantial changes to working practices, employment arrangements and contracting strategies than they felt able to do under the 5-year controls. Such changes have the potential to produce savings that benefit customers during the price control through the sharing mechanism we have and can be fully transferred to customers at the next review.

People have been telling me for years that the industry has done all it can to improve efficiency and that the scope for further gains is now very limited. The evidence does not support that.

There are also some signs – not many, but some – of companies potentially failing to deliver required outputs and in such circumstances we will of course take a hard line.

When we come to the next round of RIIO price controls we will no doubt want to review our experience of the first round and see what has worked well and what hasn't. I'm sure there will be things that we need to learn from and we will no doubt fine tune our approach in the light of those lessons. In particular we will need to ensure that the lower risks that companies are exposed to under certain aspects of RIIO are properly reflected in allowed returns.

Of course, some of these questions have recently been put to the test in the appeals to the CMA on our ED1 decisions.

For those not familiar with the regime it is now an issue-specific, merits-based appeal process and - picking upon one of Hannah's recommendations from RPI-X@20 - it allows appeal rights to third parties as well as the regulated companies.

So following our final decisions on the ED1 price controls we were subject to appeals from both sides - Centrica arguing we had been too soft on the companies in various respects and NPG arguing we

had been too tough. In total there were nine distinct grounds of appeal (with a number of detailed sub-grounds) and the CMA upheld our position on 7 and a half - which we take as fairly strong endorsement.

Certainly there was strong support for the RIIO framework from all sides –but, as always, the devil was in the detail.

The main issue on which the CMA ruled against us goes directly to the theme of this evening's lecture. In GEMA we had taken the view that the advance of technology in terms of smart metering and smart grids meant that the companies would be able to deliver higher rates of efficiency saving than they had in the past and, more importantly, higher rates than they were including in their plans.

We made various attempts to calibrate what the level of savings might be –looking at external sources as well as comparing plans across the range of companies - but inevitably it is hard to do this when you are looking into an uncertain future, with technological change and the normal problems of information asymmetry. At the end of the day the CMA concluded we did not have enough evidence to support our view that more savings were achievable than the companies were claiming.

We are concerned that this will make the job of the regulator harder when faced with an uncertain future but the CMA has been very clear that their judgement here is very specific to this case and that they recognise the challenges we face. We will consider the detail of the judgment carefully and reflect on how we can do a better job going forward.

Beyond price controls

The challenges of regulating networks undergoing transformation go wider than just setting price controls. Increasingly, we are looking at other approaches.

We have a successful competitive tender regime for offshore transmission projects which has to date delivered £2.6 billion of new finance and significant savings for consumers. We are now working to extend that approach to new and high value onshore transmission projects, as was flagged as part of the RIIO framework. And we have a new model for development of electricity interconnectors, based on a cap and floor for the returns developers can earn, which we are rolling out in partnership with neighbouring regulators. We now have 2.4GW of interconnector capacity under construction and a further 4.9GW with regulatory support in place.

Looking more widely, in last few days we have published a number of documents that consider the issues around industry transformation from different angles - looking at what we have called non-traditional business models and the demand for flexibility as an increasingly important aspect of the electricity system.

The backdrop to all this work is the feeling that we can't assume the world of the future will look like the world of the past. In fact, I think we can safely assume it won't.

Some good examples:

- Over the last few years we have seen extraordinary growth in solar farms that has substantially surpassed all forecasts made when the companies were developing their ED1 business plans. This is causing some real problems as parts of the networks reach capacity limits.

- There is also an increasing debate about the possibility of low cost battery storage combined with solar generation leading to significant numbers of customers wanting to move off the grid altogether.
- And there is a continuing debate about the implications for the gas networks of the fall-off in the use of conventional gas in response to the decarbonisation agenda – combined with the possible opening up of new uses for biogas, hydrogen, gas in vehicle transport and even the possibility of converting electricity into gas that can then be stored.

All of this means, I think, that we will have to continue to deal with substantial uncertainty in the future. In practice that means that we will need to be sure that we understand – as far as we can in an uncertain world – the range of potential futures.

That's something we started 10 years ago with our Long term Electricity Network Scenarios. It is very much what our work on non-traditional business models is about – talking to lots of people other than the usual suspects. We're also looking increasingly at international experience and trying to make sure that "horizon scanning" becomes a regular feature of how we work.

We also need to keep a watchful eye on our existing rule book to make sure that those rules don't inadvertently hinder new business models. In an industry undergoing transformation there will be new players with new business models doing different things and doing things differently. So we need to take care as a regulator to ensure that we aren't inadvertently favouring incumbents operating under a more conventional business model. Putting it more directly, I don't want smart innovations in the sector to be stopped unnecessarily by an inflexible regulatory system that simply wasn't designed for them.

And finally, for the core networks, as patterns of use change the question of how the revenues are recovered (i.e. structure of charges rather than the overall revenue control) will become increasingly important.

So, that's a brief tour of energy regulation in a changing industry. I think the core message is that although RIIO represented a big step forward in our thinking it isn't the final answer. The degree of transformation we are likely to see in the energy sector will require a continuing evolution of our approach to regulation – both for the energy networks and the sector more widely.