



SUBMISSION TO ENERGY POLICY REVIEW

1. Northern Electric welcomes this opportunity to contribute to the PIU Energy Policy Review. We would be happy to expand on the issues in this submission further in writing or in a meeting.

In this submission we argue that:

- Securing the right level of investment in infrastructure for energy delivery is an essential part of any long-term energy policy.
- The current RPI-X regulatory regime has generated significant cost savings to date, but there is general agreement among commentators that, in its present form, it is not providing adequate incentives for infrastructure investment.
- There is a need to develop the regulatory regime in a way to make it "bankable" in relation to future investment in energy infrastructure.
- A suggested outline is put forward, involving long term quality targets, a move from five year regulatory cycles towards a longer term arrangement with an adequate allocation of benefits to the investor to encourage investment and incentivise efficiency.

Northern Electric plc

2. Northern Electric is currently a major supplier of electricity and gas to domestic, industrial and commercial customers throughout Great Britain and the electricity distribution company for the North East of England. On 6 August 2001, Northern Electric and Innogy announced an innovative swap under which Northern Electric will acquire the distribution business of Yorkshire Electricity, currently owned by Innogy, and in return Innogy will acquire Northern Electric's supply and metering businesses. After completion, Northern Electric will be one of the largest electricity distribution businesses in the country, covering the area East of the Pennines from South of the Humber to North Northumberland and serving a total of 3.5 million customers.

Long Term Energy Policy

3. Any long term energy policy, particularly if it is concerned about security of supply, needs to have at its core ensuring the provision of investment in the energy industry. If this investment, whether into capital assets, the maintenance of those assets, innovation, acquisition and retention of skills and knowledge, safety or education and training, is inadequate, there is the danger that security of supply can be put at risk, perhaps catastrophically. An inadequate level of investment could arise from short-term cost reduction pressures or the lack of a stable regime in which investors feel confident they can make an adequate return. The energy crisis in California is one of the reasons for the current Energy Policy Review. The reasons for the crisis included under-investment in both electricity generation and transmission. Closer to home, we must learn the lessons from the Hatfield rail crash and avoid the circumstances which led to it arising anywhere in the energy industry.

4. Prior to privatisation, the Government could itself decide on what investment was needed in the electricity and gas industries and provide the cash to bring it about. Since privatisation, the provision of cash for investment is in the hands of shareholders and banks who have other uses for their money. If, within a market structure, the Government wishes to influence the level or direction of investment within the context of an energy policy, it needs to ensure that adequate incentives are provided to investors.

Role of Energy Delivery Infrastructure

5. To the consumer, security of supply means the secure and dependable delivery of energy to the point of use. This depends as much on the reliability of the delivery systems as on the availability of the primary sources. In the electricity industry, current levels of investment in delivery (transmission and distribution) are double that in generation (£21 billion compared with £10 billion) and turn over at twice the rate (£1.6 billion a year compared with £0.8 billion; figures from the Electricity Association website). Over the next 50 years, simply to replace existing assets will require twice as much investment in delivery as in generation.

6. Environmental concerns may well lead to changing patterns in generation. Requirements for more non-fossil generation could lead to more embedded and intermittent generation and possibly micro-CHP plants. This would require investment in network systems, which have traditionally served to deliver power from a small number of large power stations to customers. Other environmental concerns, from reducing system losses to further

undergrounding of cables, would also increase investment needs. All of this will need to be funded.

7. Traditionally, energy policy has focused on generation. While this remains an important element, it would be foolhardy to ignore the role of investment in delivery infrastructure this time.

Importance of Regulatory Regime

8. Unlike generation, electricity delivery is a monopoly and its prices are therefore regulated by Ofgem. The ability of the industry to provide continuing high quality delivery of electricity therefore depends on the nature of the regulatory regime. Over the last 10 years or so since privatisation, prices to customers have reduced by 30%, while standards have generally improved. In 1999/2000, twelve of the fourteen distribution companies had a lower number of interruptions than their ten year average, while all companies reported a higher level of availability than their ten year average (Ofgem Report on distribution and Transmission Performance 1999/2000).
9. However, it is clear that, as currently structured, the regulatory regime does not meet the requirements of a basis against which companies can raise cash for investment. Price controls have had at most five years duration, with no guarantee that they will not be reopened by the regulator sooner (cf DPRs 1 and 2). The methodology lacks clarity (at least, in terms of predicting its outcome) and has changed from review to review. The standards and targets against which companies are judged are also set for no more than 5 years forward. Although so far electricity companies have been able to raise adequate funds for investment, recent experience in the water industry, which has a very similar regime, speaks for itself.
10. This has been recognised by a number of observers. To quote the PIU's own scoping note on gas, "there has been an increasing recognition that, whilst [RPI-X] was a successful mechanism for exerting a downward pressure on cost and prices, it may not always have been the most appropriate incentive for encouraging long-term investment." This is supported by a wide range of commentators. Anthony Hilton, in the Evening Standard on 9 February, pointed out: "If there is going to be enough water, gas, electricity or rail transport for the country in 20 years, planning and investment decisions need to be taken now. But they will only be taken if the regulatory regime has a similar long term view and will deliver the certainty and security of return that makes long term investment possible. This is not what is happening." Mark Bentley, a managing director of J P Morgan, is quoted in a European Policy Forum pamphlet, "The Politics of Regulation", last year as saying: " It is now extremely difficult to make money in the electricity supply business. Many of the inefficiencies have been identified and eliminated. In the longer term,

many RECs will need to find substantial capital sums for investment. There is a real danger that the regulator will not allow shareholders to earn an appropriate rate for return on their investment. The last regulatory review of prices in the electricity sector was swingeing.” Lord Haskins, in launching the Better Regulation Task Force's report on Economic Regulators makes the same point, as does Dieter Helm in a recent series of articles.

A Way Forward

11. But what should the current regime be replaced with? Dieter Helm argues that we should move away from five year periodic price reviews and replace them with a system that minimises regulatory risk and restores certainty to the regulatory process. As he points out, “Five year, fixed price contracts – the conventional approach under RPI-X regulation – are often ill-suited to industries where investments can take years to plan, obtain the necessary planning permission, and execute, and where assets lives are typically measured in decades”. He adds, “The private sector has developed all sorts of innovative ways to address these problems, and fixed-price, five year contracts are not common”.
12. The introduction of competition into electricity and gas supply has led to the concentration of conventional price control regulation onto the monopolistic wires businesses. This has helped clarify the nature of the regulatory relationship. It is now much more akin to a contract between regulator (as proxy for the customer) and company under which the company delivers a product (measured by a set of quality indicators) in return for which the company is paid a stream of income. As such, as Helm says, there are useful private sector analogues.
13. A longer term regulatory regime implies the need for Ofgem to set long term quality of supply targets. In the absence of such targets, it is difficult to see the basis on which companies are expected to invest. At present, quality targets are only set for the period of the regulatory review. Achievement of these targets is not simply a question of the level of capital investment in the period. Ofgem has shown a marked reluctance to determine the appropriate long-term quality targets, preferring instead to search for comparator-derived solutions to quality. Individual customer choice might be appropriate (and indeed feasible) for some larger users. But it is difficult to see how the interests of domestic consumers can be fairly met without the regulator determining on their behalf the level of service that the network company should provide, given that the trade off between cost and quality will have a different outcome in different parts of the country.
14. In looking at what form such a regime might take, it is worth considering what investors and consumers require from it. Investors need:

- Reasonable certainty of a basic rate of return with opportunities for upside
- No surprises
- Encouragement of a business-driven culture that promotes cost-effectiveness
- Clarity on objectives

Customers (and therefore their proxy, the regulator) need:

- Delivery
- Cost effectiveness

15. This suggests a possible regime based on:

- Long term quality targets
- Monitoring and control related to reaching milestones towards achieving these targets, ie a move away from intrusive management of inputs towards a genuine customer's interest in outputs.
- Long term indicative income levels based on achievement of these milestones. Base income levels to be determined for (say) a rolling 20 year period to allow for appropriate investment decisions.
- Ensuring the company benefits from cost reductions achieved in excess of the implied cost levels. The formula must be set to allow the company an adequate return on improvements, whilst providing that over time customers benefit as well.

16. At present, the regulatory process does not identify genuine "best practice". High cost companies are assumed to be "bad" and low cost companies are considered to be a model to be copied, regardless of whether their activities are genuinely cost-effective or jeopardising their long-term impact on quality of supply. This simply encourages companies to compete to minimise costs in the short term and penalises any attempt at longer term maintenance of quality and security of supply. An approach grounded in the circumstances and needs of each licensee would rectify this and could even encourage sharing of best practice.

Conclusion

Ensuring cost-effective investment for the long term is not easy under a regulated monopoly regime. Nevertheless, it is a vital part of any long-term energy policy. This paper has suggested a possible way forward.