

SEEBOARD plc INPUT TO ENERGY POLICY REVIEW ON INFRASTRUCTURE INVESTMENT AND REGULATORY ISSUES

- 1 The purpose of this short submission is to respond to some of the issues raised at the recent PIU/EA Workshop held on 13 September 2001. It focuses on the question of infrastructure investment and the extent to which the development of energy networks can be facilitated by the current form of price regulation.

INFRASTRUCTURE INVESTMENT (Relating to electricity distribution)

Access Pricing

- 2 The question has been raised about the extent to which network users should pay cost reflective prices. Given the nature of the distribution network, it is not realistic to charge individuals, except the very largest non-domestic users, differently - hence present use of system charges incorporate a necessary degree of averaging (albeit from marginally derived costs) between groups of different users.
- 3 Not only has this the benefit of simplicity but recognises that, since virtually all those taking electricity from the networks would be unable to respond to more specific pricing signals, there is no benefit from improved cost reflectivity. What is an issue, however, is the wide range of use of system charges across the country which it is difficult to believe is all explainable by inherited and inherent differences between network operators.
- 4 For generation connected into the distribution networks, however, cost reflective charges are desirable since siting of such plant is more able to respond to such signals. However, as referred to in paragraph 14 below, a significant expansion of embedded generation would require a radical re-appraisal of network regulation as it would change the design and operation of such networks.

Need for Investment

- 5 The primary objective of network operators should be to provide and maintain a network which meets the needs of its users at minimum long term cost. This requires appropriate incentives to be in place (these are currently inadequate, see paragraphs 18-20), with regulatory constraints kept to a minimum, and clarity about the desirable level of robustness that the network should provide.
- 6 User needs from the distribution networks are best determined from a combination of direct discussions with the largest users, by carrying out structured customer surveys for other users coupled with the judgement of network operators as to the trade-offs between changing security and cost (both in terms of investment in equipment and the societal costs of not having a continuous supply). The use at this level of market based instruments such as auctions would be too complex, costly and totally inappropriate.

Security

- 7 We do not feel that more needs to be done to encourage consumers to consider their security needs. This already happens for the bigger commercial/industrial customers where it is often possible to provide different levels of quality of supply. For the generality of customers, however, it is not feasible to differentiate in this way, so decisions on the appropriate level of security to provide should be determined from a consideration of what society is willing to pay.
- 8 This is particularly relevant when considering whether there is a case for deliberate gold plating. In our view the answer to this is no. However, we accept that there is a risk that current regulation can lead to short termism and does not factor in the implications of network failure on society at large. This suggests that, in determining appropriate levels of security, the societal costs should be included in the assessment.
- 9 The ability to finance future investment requires equity markets! lending institutions to have confidence that the regulatory regime is reasonably stable. This confidence would be improved by establishing now an agreed framework setting out the basis of the

next distribution price control review. In the absence of such a framework, any investment which does not payback within the short term may be regarded by companies as too risky in that the regulator might decide to exclude it from the regulatory asset base on which the allowed return is calculated.

Environmental Factors

- 10 We believe the answer is yes to the question of "should network access and trading arrangements be "technology blind"". To do otherwise would distort decision making by the network operator and lead to the development of sub-optimal networks.
- 11 Reference is made to how the environmental impact of overhead lines should be internalised. However, it is inappropriate just to single out overhead lines since other equipment, including underground cables, are not necessarily environmentally benign. From a pure economic perspective, fully reflecting all costs, including environmental, in energy prices would signal the right messages; such an approach, however, could be politically difficult since it would significantly increase the price of energy, particularly affecting the vulnerable customers. Consequently, if a government wanted to ease such a burden, this should be done in a transparent way by providing direct help for those most affected, for example via the taxation system.

The Long Term

- 12 Rather than develop a single vision of the distribution network in the long term, there would be value in developing a number of scenarios which could be used to understand better the implications of alternative futures. This is particularly important given the wide range of uncertainties facing the network: for instance, connection of embedded generation, energy efficiency/demand side impacts, lifestyle changes impacting load curves, transport policy, housing/planning policy, and the level of quality of supply between customer groups.
- 13 One scenario, for example, could be based around a future with a large amount of embedded generation/micro CHP, identifying what this would mean for the design and operation of the network, and the associated costs, including the environmental implications

of manufacturing and installing new equipment. This scenario would also need to consider issues such as who should be in overall control of embedded generation targets to make it happen. On the last point, the development of the network (for instance whether to reduce losses or facilitate connection of embedded generation) is not environmentally neutral - the carbon emissions attributable to the manufacture and installation of the network reinforcements must be offset against the environmental benefits that these are designed to support.

- 14 What is clear is that the present regulatory system is not designed to deliver non-marginal changes, such as might be required under a future with significant embedded generation. Hence if it is shown that major changes are required to networks to facilitate embedded generation, then the regulatory approach would need to be changed for this to happen.

REGULATORY ISSUES

Role of Ofgem

- 1 5 Ofgem's role should be that of an independent, economic regulator, free from interference by government. It should not, however, determine issues of national energy policy which, by default, there is a risk of it doing in the current absence of a clear policy framework within which to operate.
- 1 6 How to establish and manage such a high level framework needs careful thought. One suggestion put forward is the establishment of a statutory strategic energy agency. This could have the benefit of setting a long term framework within which the regulator can develop appropriate regulatory mechanisms, distributors can efficiently invest in networks, manufacturers have the confidence to develop new products and users can understand how to develop their use or production of energy efficiently. However, before setting up a new body like this, it is essential to:
- (i) not move back to a form of central planning where the 'how' as well as the 'what' is specified;
 - (ii) provide clear accountability, with a minimum of

bureaucracy;

(iii) not provide the solutions but allow the market to do this with a minimum of intrusion;

(iv) avoid encouraging inefficient investment.

17 Transparency in regulation is essential and Ofgem has made important strides in this direction over the last few years. However, more still needs to be done - in particular:

(i) Ofgem is trying to tackle too many issues, with the inevitable result of insufficient time being given to the important topics, slippage and a tendency to inadequately consider comments received and explain why these were not taken on board;

(ii) the BRTF recommended that regulators should carry out regulatory impact assessments - we therefore find it concerning that Ofgem is showing a reluctance to do these, resulting in some cases in unjustified work.

Type of Regulation

18 The current form of RPI-X regulation has worked well in removing the inefficiencies of nationalisation. However, there are weaknesses in the methodology of setting price controls which need to be urgently addressed. These include;

(i) perverse incentives on companies between the spending of opex and capex;

(ii) uncertainty over the methodology to be followed at price reviews which can impact on future investment;

(iii) increasing regulatory requests for detailed information on the network businesses;

(iv) insufficient incentives to encourage companies to balance risk and reward;

(v) a disconnect between short term service targets and investment cycles.

- 19 We, and other companies, have been urging Ofgem to open discussions without further delay on the basis to be adopted for the next distribution price control review. There is a need to address weaknesses such as those mentioned above and to agree upon the regulatory principles underpinning the price regulation of networks. In particular, there needs to be:
- (i) less emphasis on 5 yearly reviews;
 - (ii) effective incentives (with symmetrical benefits/penalties) on companies to meet, over the long term, customer needs at least cost, perhaps with some contractual arrangement;
 - (iii) the use of total costs (combining opex and capex in an agreed way);
 - (iv) output targets to be set which reflect customers' preferences and willingness to pay.
- 20 Such a review of price control setting principles would have added urgency if, as a result of this Energy Policy Review, the nature of the distribution network has to change to accommodate, for example, much more locally connected generation.
- 21 We have given considerable thought to how regulation could evolve and would very willing to play a leading role in the development of an improved regulatory regime.