Just how immune are GB energy networks from policy uncertainty?

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Context: relative policy vulnerability of energy markets and energy networks

• Energy (as with utility areas generally) is normally a highly political area
  • its contemporary political salience being reflected in whether or not there is a Department of Energy at the time – which, in turn, has tended to reflect what has been happening to global energy prices

• Electricity and gas market’s high political profile and exposure to policy changes
  • impact on policy of the rises in retail energy prices
    • political pressure on Ofgem to ‘do something’, leading to restrictions on price discrimination, limiting of number of tariffs and the CMA market investigation
    • threats of price freezes and, more recently (CMA), price controls
  • EMR’s continuation of the substitution of subsidy and administrative decision-making (CFDs and the Capacity Mechanism) for the wholesale market
    • followed by (still ongoing) twists and turns in subsidisation of low-carbon energy

• Compared to this, energy networks have appeared somewhat insulated from political/policy changes
Energy networks do face risk/uncertainty

• 8 year (more or less fixed revenue) price controls, albeit with 'uncertainty mechanisms'

• At least for some (big) enhancement projects, increased regulatory focus on network contestability, partly driven by WACC numbers from
  • offshore transmission
  • Thames Tideway
    with obvious potential implications for future rates of return on core networks

• Underlying uncertainty about consequences of asset stranding, especially for ‘declining’ networks, driven by some mixture of
  • technological change (e.g. behind-the meter-generation)
  • resource depletion (gas transmission)
  • declining demand which could have a policy dimension
  • new entry at different stages of the value chain

• Some people still remember the Windfall Tax
But

• Whatever the impact of policy change on some network issues, e.g.
  • Access
  • Charging

• Network revenue/profitability has been relatively insulated
  • Regulators (Offer, Ofgas, Ofgem) have been more or less left to get on with setting network price controls
  • By and large, regulators have avoided arbitrary (or politically sensitised) changes in setting price controls
    • May have been efforts to keep headline price changes within a range of political acceptability but WACC changes (and, therefore, returns to investors) have typically been based on market evidence (and have lagged capital market trends)

• How sustainable is this (relative) freedom from political interference?
  • To some extent (but not entirely), reducible to a question about the sustainability of independent regulation
‘Independent’ energy regulation Version 1 (1990sish)

- Energy policy largely subsumed in promotion of competition (give or take the odd gesture to nuclear or coal) and thus, effect, contracted out to regulators
- Offer and Ofgas charged, in effect, with
  - promoting competition where possible
  - preventing monopolies (initially covering supply as well as networks) from exploiting their monopoly power
- Windfall tax apart, policy exposure meant regulatory exposure
- For networks, regulatory risk mainly a matter of reducing (quite substantial) economic rent
  - 1995 re-opening of electricity distribution price controls
  - British Gas’s (largely self-inflicted) battles with Ofgas
Version 2 (from then until now)

- Driven by mixture of
  - change of government in 1997
  - Utilities Act 2000
    - rebalancing of regulator’s obligations
  - Energy White Paper of 2003
    - formal recognition of decarbonisation alongside security of supply and affordability – creating conflict especially between decarbonisation objective and Ofgem’s primary duty to consumers, assumed by Ofgem to be significantly about price
  - EMR

- Resulting in
  - Modification of Ofgem’s statutory obligations in successive Energy Acts
  - Shrinkage of Ofgem’s scope
    - DECC taking increased responsibility for wholesale markets and network access
  - Strategy and Policy Statements which, within the framework set by the Energy Act, set out what DECC wants Ofgem to achieve
    - Aim is that Statements will not usually be more frequent than one per Parliament and will leave Ofgem ‘independent’ in a day-to-day sense

- Bottom line is that Ofgem still left to get on with network price controls without substantial political interference
What Ofgem does and does not do

<table>
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<th>Core Ofgem</th>
<th>Grey area</th>
<th>DECC</th>
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<td>‘Routine’ network regulation – e.g. price reviews</td>
<td>Significant changes to network regulation, especially when important to delivery of policy outcomes (e.g. transmission access and pricing)</td>
<td>‘Big’ changes to structure of energy markets, e.g. EMR</td>
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<td>‘Delivery’ of specified programmes - Eserve</td>
<td>Tweaking of operation of wholesale and retail markets</td>
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Version 3?

- From a network point of view, current position underpinned by survival of Tory - (Old) New Labour consensus on the appropriate division between market and state activities
  - and acceptance of the importance of adequate and stable rates of return to underpin private sector investment in infrastructure
- In addition, periodic price review give a safety valve, not there with longer term contracts (PFI, CFDs?), for very high rates of return
  - thus reducing risk of a government rent grab
- If, however, political centre of gravity substantially shifted, then (and select whatever cliché one wants) this would be a potential game changer