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4 September 2017

Open letter on the RIIO-2 Framework

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, storage, and energy supply to end users. We have over five million electricity and gas customer accounts in the UK, including residential and business users.

We welcome Ofgem's early engagement on the RIIO-2 Framework and the opportunity to respond to Ofgem's initial thinking. As recognised by Ofgem, the energy system will continue to transform, with many uncertainties about the direction and pace of change, over the next price control period. While we would like to see tougher incentives that deliver the best possible outcome for consumers, network companies must be funded adequately and be able to make fair returns to deliver and maintain secure, robust and reliable systems that supports the transition to a low-carbon future.

We broadly agree with Ofgem's view that the overarching objective for RIIO-2 should be to "ensure regulated network companies deliver the value for money services that consumers want and need." Network companies will need to be mindful that the energy system is evolving, and they need an approach that can tackle future challenges, and make the most of future solutions. We would like to see network companies being open to new approaches, working closely with each other and also with the system operator (SO). Although the RIIO process for the TOs, the distribution companies and the SO are not aligned, carefully designed incentives to encourage them to work together should be sufficient to gain the synergies.

We support the principle of consumers being involved and having a stronger voice on setting outputs, shaping and assessing business plans. However, weak consumer engagement is a persistent issue with energy retail even when savings of £200+ can be achieved. We suspect it would be even harder to get consumers involved in networks outputs. While consumer bodies like Citizens Advice can express a view, it is only Ofgem that can act on behalf of current and consumers and must take a strong role in setting output targets and incentives. From our perspective, we want stable, value for money network charges; good network performance in terms of availability and restoration; robust customer services; and robust provision of services to support the smart metering roll-out.

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Regulated companies must be able to earn returns that are fair and represent good value for consumers. Reflecting on the returns made during RIIO-1, we note that the majority of network companies are delivering strong earnings, several earning double digit returns on the Return on Regulatory Equity (RoRE). If this derives from companies outperforming by innovating and delivering more cost effectively, then this demonstrates the regulatory approach is working. However, there is some evidence that the RIIO1 controls have been generous to network licensees. We believe that the parameters used to define the Weighted Average Cost of Capital (WACC), in particular cost of equity, is currently in favour of network companies and must be scrutinised for RIIO-2 to ensure that they reflect the risks faced in these businesses and prevailing financial market conditions. In terms of out-performance, it is currently very difficult for third parties to understand the reasons for out-performance. For example, we are concerned that some network companies may be simply deferring their network spend, at the risk to their asset health. If this was the case, then such an action should not warrant a reward. However, without transparent reporting of asset health, it is impossible to understand whether there is a correlation between the two. Going forward, it would be useful if network companies could report on their asset health alongside their performance and outputs in Ofgem's Data Portal. It would also be useful if Ofgem could publish a periodic decomposition of RoRE so that stakeholders could see where outperformance is being generated.

Networks will need to evolve to take opportunities to reduce costs and improve service, in particular with respect of smart technologies. However, we believe that caution is required given that the costs of new approaches are typically uncertain and risks being over-incentivised (in particular, there is likely to be information asymmetry between the network companies and Ofgem). There will also need to be increased co-ordination between local and national networks as the former become more actively managed. To this extent, it will be important to minimise market distortions.

We look forward to continuing to engage on these matters. Should you wish to discuss any of the issues raised in our response or have any queries, please contact Mark Cox on 01452 658415, or me.

I confirm that this letter may be published on Ofgem's website.

Yours sincerely,

A handwritten signature in dark ink, appearing to read "Angela Hepworth".

Angela Hepworth
Corporate Policy and Regulation Director