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Submitted electronically to RIIO2@ofgem.gov.uk

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Response to: Open letter on the RIIO-2 Framework

Dear Jonathan

innogy SE is a newly established European Energy company. Formally part of RWE AG, innogy SE has three business segments: Grid & Infrastructure, Retail and Renewables. The UK is a core territory for both our Retail and Renewables segments.

Please find attached our response to the Open letter on the RIIO-2 Framework. This reflects the views of innogy SE's UK segment: npower and innogy renewables UK Ltd.

Kind Regards

Helen Inwood

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Network Charging Manager
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RIIO-T2 Questions

1. Do you agree with our overarching objective for RIIO-2 and how we propose to achieve it?

While we agree that it is important that network companies deliver the value for money services that customers want or need, this overarching objective does not provide scope to ensure that these are the right services. We believe RIIO-2 should minimise costs for both today's and future customers. It is about investing in a secure network that is able to meet the challenges and changes moving forward.

2. How can we strengthen the consumer voice (primarily end-consumers), in the development of business plans and price control decisions?

RIIO-1 improved the way that Network Operators engaged with end consumers. We agree that it is important to strengthen the consumer voice in the development of business plans and price control decisions. However, the ability of Network Operators to do this is more likely to be limited to dealing with consumer bodies, larger consumers, local authorities and local interest groups.

In the Ofgem SCR Launch Statement (4th August 2017), Ofgem have recognised that 'as network charges are not directly levied on most end-consumers, we think that fairness of network charges to suppliers can be seen as a proxy for fairness to consumers'. In line with this approach, we would suggest that suppliers should also be regarded as a key customer voice in the business plan development / price control decision making process. Suppliers can also play a part in communicating the RIIO-2 process to their customers.

3. How should we support network companies in maintaining engagement with consumers throughout the price control period?

We agree that the onus should be on network companies to determine the best way of engaging with their customers, but there should be a mechanism of measuring the effectiveness of this engagement. This measure should be determined by Ofgem, and, where possible, use best practice from the more formal approaches to customer engagement taken in other sectors.

4. Does this structured approach to defining outputs provide the right level of clarity around delivery?

We are not close enough to this area in RIIO-1 to comment as to whether or not the outputs require the right level of clarity around delivery. The effectiveness of this approach should be determined by Ofgem. We would be keen to see Ofgem's conclusions on the effectiveness of this approach, and any gaps or improvements identified should be built into RIIO-2.

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5. How can the outputs framework be improved, including the introduction of additional output categories for example around efficient system operation for distribution network companies?

It is important that the output framework is appropriately constructed to ensure that Network Operators are being measured correctly. We agree that an additional output category is required to incorporate DSO changes. This must reflect and complement work being carried out by other Industry groups in this area.

6. Did the outputs target the right behaviours?

We are not close enough to this area in RIIO-1 to comment, but, as per our response to Question 4, we would be keen to see Ofgem's conclusions on the effectiveness of this approach, and any gaps or improvements identified should be built into RIIO-2.

7. How can we address areas of expenditure for which a clear output is difficult to define?

An 8 year price control does provide challenges in terms of predicting requirements for the future. This will become even more difficult in RIIO-2 due to the changing nature of how the network is used. The solution needs to be flexible, as well as providing clarity ahead of time. However, unexpected cost adjustments at short notice should be avoided. The period of notice for the annual iteration process should be extended to provide greater notice MOD term of the mod term adjustment to revenues.

8. Were the output targets and associated financial incentives set for RIIO-1 appropriate, reflecting what consumers value and are willing to pay for?

RIIO-1 was a large improvement on previous price controls in that Network Operators were more engaged with their customers. Again, we do not feel we have seen enough information on the outcomes of targets and associated financial targets to be able to meaningfully comment on value to consumers. We would like to see Ofgem's conclusions on the success of these objectives.

9. What changes in the RIIO framework would facilitate returns that are demonstrably good value for consumers?

There needs to be a smooth transition between RIIO-1 and RIIO-2 in order to reduce risk premia required by suppliers for non-pass through contracts and to provide customers on pass through contracts and generators with more certainty of the costs. The revenues that Network Operators can collect from tariffs needs to be published much earlier in the process.

<u>RIIO-2 is currently a 'cliff edge' for customers on pass through contracts, and for suppliers and generators. All are exposed to the absolute costs of tariffs, without being able to pass these through into contracts</u>.

The market does not know whether Network Operator allowed revenues will go up or down from the beginning of the new price control – or to what extent? Notification of allowed revenues very late in the process (as per RIIO-1) causes issues for suppliers since it makes forecasting of the Network charges for customer pricing very difficult. This uncertainty will result in the need for suppliers to increase risk premia in customer contracts to cover the risk on these large non-hedgeable costs. This may result in customers on non-pass through contracts paying more than they should for Network costs. It may also result in significant price changes for pass through consumers, a price shock that they cannot foresee or budget for if there is a step change in revenue published at short notice. Generators are also unable to price through those costs into the market. Generators will need to also know the outcomes of any re-zoning activity early on. This could significantly affect their tariffs, and therefore their economics.

Late notification of allowed revenues is also a major issue for DNOs now that DCP178 has been approved. If the timescales for RIIO-2 are kept in line with RIIO-1, non-fast tracked DNOs will not know their final allowed revenue at the time of publishing final tariffs (15 months' notice) for the first year of the price control.

Under RIIO-2, Ofgem need to consider how to align the process in order to smooth the transition from RIIO-1 into RIIO-2. <u>One option would be to fix revenues for the first year of the price control early and then to apply an adjustment across future years of the price control once revenues are known. *(Ofgem used this approach towards the end of RIIO-ED1, bringing forward the notification of allowed revenues for non-fast tracked DNOs from November 2014 to July 2014*).</u> Ideally, we would suggest that the first year's revenues are fixed 15 months to 2 years ahead of the start of the new price control – with the adjustment done in future years. This provides more certainty to the market on likely costs as well as ensuring DNOs know their allowed revenues in advance of setting final tariffs. It removes that 'cliff edge' while still ensuring that network operators can recover their total revenues. Alternatively, the RIIO-2 timetable should be revisited to publish all Allowed Revenues much earlier than in RIIO-1 (at least 15 months' notice to 2 years notice).

10. How can we minimise the scope for forecasting errors?

We are concerned at the high level of returns that Network Companies are expected to achieve during the course of RIIO-1. Monopoly companies should not be making windfall gains through forecasting errors. Ofgem should implement a process which reviews and corrects for forecasting errors should it be determined that a company has made excessive gains as a result.

11. What constitutes a fair return for a regulated monopoly network company, and how can we ensure that returns remain legitimate in the eyes of stakeholders?

The report issued by the Citizen's Advice Bureau does raise valid questions about the levels of returns for monopoly network companies and we would urge Ofgem to consider the questions raised. We believe 'a fair return' for a regulated monopoly network company should be comparable to returns made by businesses with a similar risk profile. We would suggest that the high returns that are currently expected in RIIO-1 should be limited only to the best performers, it should not be the 'norm' and simply a bi-product of the price control.

We note that, while Network Operators can apply for an Income Adjusting Event should the price control result in them being treated unfavourably, this does not happen in the event that Network Operators are treated too favourably as a result of Price Control assumptions. This review process would provide more consumer confidence that the Network Operators are making fair returns that are not biased by the price control process.

12. What factors do you think are relevant for assessing and setting the cost of capital so it properly reflects the risks faced by companies?

We welcome Ofgem seeking expert academic advice to understand the cost of capital implications. This is clearly an issue under RIIO-1 and needs to be corrected.

13. Can we improve our methods for the indexation of the costs of debt and equity?

Yes, this is clearly a major issue under RIIO-1. The indexes used should be more representative of the market conditions that the Network Operators face e.g. indexes calculated over a more recent period.

14. Are there specific amendments to any core aspects of financeability that we should be considering in light of performance during RIIO-1 and the change in the financial environment?

We believe this is for Ofgem to consider.

15. Should we consider moving to CPIH (or another inflation index) and how should we put into effect any change to ensure it is present value neutral for investors?

Ofgem should move to CPIH as the index for inflation.

16. Do you think there are sufficient benefits in aligning the electricity price controls to off-set the disadvantages we have outlined?

The electricity price controls should **not** be aligned unless the current 'cliff edge' (see Q9) is resolved. The market does not know whether Network Operator allowed revenues will go up or down from the beginning of the new price control – or to what extent? Aligning price controls increases the level of uncertainty even more – and will result in the need for suppliers to increase risk premia even more to cover the risk that would have previously covered 2 completely separate periods. Please see answer to Question 17 for further details. Ofgem should look at how to smooth the transition between RIIO-1 and RIIO-2 in order to avoid price shocks and to provide transparency and predictability of Network Tariffs to the market, and therefore consumers.

Aligning the price controls would also result in concentrating a large amount of work for market participants and Ofgem over a shorted period, putting at risk the quality of the process.

17. Are there any other realignment options we should consider?

Yes. As per Q9. Ofgem should look to enabling a smooth transition between RIIO-1 and RIIO-2. *It is important to recognise that he market needs clarity and transparency on allowed revenues in the years leading up to RIIO-2*. RIIO-2 is currently a 'cliff edge'. No one in the market knows whether Network Operator allowed revenues will go up or down from the beginning of the new price control – or to what extent? Notification of allowed revenues very late in the process causes issues for suppliers since it makes forecasting of the Network charges for customer pricing very difficult. This uncertainty will likely result in the need for suppliers to increase risk premia in customer contracts to cover the risk on these large non-hedgeable costs. It may also result in significant price changes for consumers, a price shock that they cannot foresee or budget for if there is a step change in revenue. The same is true for generators, who need to know what the cost of operation will be.

Late notification of allowed revenues is also a major issue for DNOs. If the timescales for RIIO-2 are in line with RIIO-1, non-fast tracked DNOs will not know their final allowed revenue at the time of publishing final tariffs (15 months' notice) for the first year of the price control.

Under RIIO-2, Ofgem need to consider how to align the process in order to smooth the transition from RIIO-1 into RIIO-2. One option would be to fix revenues for the first year of the price control early and then to apply an adjustment across future years of the price control once revenues are known. (Ofgem used this approach prior to the start of RIIO-ED1, bringing forward the notification of allowed revenues for non-fast tracked DNOs from November 2014 to July 2014). Ideally, we would suggest that the first year's revenues are fixed 15 months (in line with the DUoS tariff publication timescale) to 2 years ahead of the start of the new price control – with the adjustment done in future years. This provides more certainty to the market on likely costs as well as ensuring DNOs know their allowed revenues in advance of setting final tariffs. It removes that 'cliff edge' while still ensuring that network operators can recover their total revenues. Alternatively, the RIIO-2 timetable should be revisited to publish all Allowed Revenues much earlier than in RIIO-1 (at least 15 months' notice to 2 years notice).

18. What amendments to the RIIO framework, if any, should we consider in supporting companies to make full use of smart alternatives to traditional network investment?

Ideally the RIIO framework should incentivise network companies to tender out jobs where they see the need for 'traditional network investment' – if the market can come back with more cost effective smart alternatives then these should be implemented. It is important to recognise the difference between 'cheapest' and 'most cost-effective' in this context.

What might be cheapest for the consumer in the immediate term may not represent the best value for money over the course of one or more price controls.

19. Given the uncertainty around demand for network services, how much of an issue might asset stranding be and how should this risk be dealt with?

Regarding recoverability of costs, the recently announced SCR should assess what the appropriate charging base will be in future years, and this should reflect the changing nature of consumer participation and moving towards a smart grid. Network charges should be recovered from the whole connection user base in a manner that is proportionate and transparent.

We share the concerns regarding stranded assets. Technical solutions, such as headroom, could be reviewed and flexible solutions such as un-firm connections are exceptionally important in this regard. Some, but not all, DNOs offer un-firm connections. We would like to see such connections being offered by all where it can speed up connection. DNOs and TOs must be more aligned in their work to reinforce and/or create room on the networks. By working together, and engaging industry in the process, connections can become more efficient. Network Operators must embrace flexible options which seek to offset reinforcement costs, but not shy away from reinforcing where it is required and to ensure security of supply.

20. How do we need to adapt the RIIO framework, and the uncertainty mechanisms in particular, to deal with this uncertainty?

One possible route would be to have a 'rolling price control' – with business plans agreed and allowed revenues set every 2 years, each iteration 2 years ahead of time. This will provide more certainty and transparency during the price control period.

21. Is an eight-year price control period with built-in uncertainty mechanisms still appropriate given the greater range of plausible future scenarios?

Given the uncertainty that will arise from the rapidly changing nature of the network, it does bring into question the viability of an 8 year price control. However, as we have suggested above, possible route would be to have a 'rolling price control' – with business plans agreed and allowed revenues set every 2 years, each iteration 2 years ahead of time. . This will provide more certainty and transparency during the price control period.

22. What improvements should be made to the assessment of business plans?

While we appreciate that there is a very large amount of information to be reviewed, we believe that timescales should be brought forward from RIIO-1, both for initial publication and for review.

23. Should we give further consideration to companies' historic performance against their business plans?

Yes.

24. Should we determine the revenues an "efficient" network company requires before seeking information from the companies themselves?

We would support this approach by Ofgem in order to challenge the Business Plan numbers.

25. What has an eight-year price control period allowed network companies to accomplish or plan for that would not have occurred under a shorter price control period?

The Network Operators are better placed to comment on the benefits of an 8 year price control.

26. How well has the IQI and efficiency incentive worked in revealing efficient costs through the business plan process and encouraging efficiency throughout the price control period?

We are not close enough on this to comment for RIIO-1 but would welcome a review by Ofgem. In particular, they should look at whether the costs forecast by Network Operators were reasonable compared to outturn.

27. What alternative approaches could we consider to encourage companies to give us high quality information that minimises the damage from their information advantage?

There should be some comparison of information across Business Plans to ensure consistency across Network Operators.

28. What impact has the innovation stimulus had on driving innovation and changing the innovation culture?

We are not close enough on this to comment for RIIO-1 but would welcome a review by Ofgem.

29. Have the incentives inherent in the RIIO model encouraged network companies to be more innovative and what should we consider further?

We are not close enough on this to comment for RIIO-1 but would welcome a review by Ofgem.

30. Do you agree that the scope of competition should be expanded in RIIO-2? What further role can competition play?

We agree that competition should be used where it can drive better value for consumers. We would caution however against equating value with lowest possible capital cost. Evaluating existing competitive models' value for money in order to benefit RIIO-2 will require critical evaluation of those competitive regimes to assess their strengths and where they could be improved. It is important to recognise that competition-driven regimes should not compromise the long-term value for money for the consumer. Whilst driving down prices quickly is positive for the consumer in the short term, a network designed for longevity and allowing for innovation might not be procured at the cheapest capital cost. Cheap capital cost does not necessarily correlate with the best value for the consumer over the course of a number of price controls. It is absolutely critical to long-term success that Ofgem recognise this and incorporate this into their decision-making processes.

31. Which elements add the most complexity and how do you think that these and the broader RIIO framework could be simplified?

The changing nature of the Networks in RIIO-2, and the ability to predict that – will provide most complexity over the next RIIO price control. Plan revisions will be necessary but should be for 2 years in advance to provide transparency of costs to market participants.

32. What improvements could be made to the format and presentation of the business plans?

Under RIIO-1, we found business plan summaries most helpful, and Network Operator individual presentations useful. We would, however, like to see early on in the process, a view of allowed revenues by network operator for the whole price control period (high / medium / low scenario) for reasons expressed in Q9.

33. Should the plans be revised at any stage during the price control, for example annually?

Yes, the network is expected to be changing rapidly during the next price control and the plans should be revised. However, any changes and associated allowed revenue adjustments should be published 2 years in advance to provide transparency and certainty.

34. Should we retain fast tracking and if so, for which sectors?

Given that Network Operators have been through RIIO-1, they should all have a good view of what is expected from them. We would suggest the norm becomes fast tracked – with only a few that are non-fast tracked if the quality of their business plans is below the required standard. This also helps to avoid the 'cliff edge' for customers and the market between price controls (please see our answer to Q9).

35. Do we collect the right information in the right format and are there better ways to monitor the performance of companies?

We are not really in a position to comment.

36. What are your views on how the changing role of the electricity SO should be factored into the RIIO framework, including whether or not the electricity SO should have a separate price control?

Yes, SO should have a separate price control.

37. Do you agree with our broad stakeholder engagement approach set out above?

We support the proposal of working groups but, given the wide range of interests across customers and industry, we would suggest to focus on separate sessions for participants who have a common interest in order to get the best outcome / debate. E.g. separate sessions for large consumers, small consumers, industry participants etc. This will give a clearer picture on what is important to different groups and potentially allow more detailed discussion.