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Open letter on the RIIO-2 Framework - RWE Response

Dear Jonathan,

RWE welcomes the opportunity to respond to the Ofgem consultation on the "Open letter on the RIIO-2 Framework" (the Open Letter) published on 12th July 2017. We are responding on behalf of RWE Supply and Trading GmbH and RWE Generation plc. This is a non-confidential response.

The price control regime is fundamental to the regulation of the GB gas and electricity market. It impacts on the operation of the capacity, wholesale and retail markets which are subject to a particular period of change. Potential outcomes and the future opportunities for the industry are more uncertain than ever. This reflects the developments in the political environment, the impact of new smart technologies, electric vehicle deployment, cheaper renewables and climate change initiatives. In this context the price control regime must be flexible enough to reflect change and ensure that it does not lock the network companies into particular pathways.

Ofgem have recognised the major challenges for the price control regime in the Open Letter. Clearly we are at an early stage of development, and we welcome the intention to consult widely with market participants and consumers in the process. However, as is the case with recent periodic reviews, there is considerable informational asymmetry between market participants, customers, the regulated network companies and the regulator. A balance must be struck between transparency of information and commercial confidentiality of wider industry plans. In this context it is important that there is sufficient trust in the process so that the outcomes are legitimate and not subject to future challenge. On this basis the wider industry can plan for the future with some confidence.

Our detailed comments on the questions in the Consultation Document are included in Annex 1.

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If you have any comments or wish to discuss the issues raised in this letter then please do not hesitate to contact me.

Yours faithfully

By email

Bill Reed
Market Development Manager.

Annex 1: RWE Response to the Open Letter questions

Chapter 2

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

We agree with Ofgem's overarching objective for RIIO-2.

Ofgem are suggesting that "*greater coordination across traditional network boundaries will be required"* (Page 5). We support this aim, but further clarification is required. It is possible that structural changes may be required in order to deliver the "greater coordination" with, for example, greater alignment between the incentive schemes for the system operation and the functions associated with network ownership. In this context greater convergence of certain functions between transmission and distribution system operation may be necessary, perhaps through joint operation (e.g. managing constraints, frequency control or system inertia).

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

We welcome Ofgem's initiative to encourage greater participation of customers when setting the price controls.

Informational asymmetry exists between the regulated network companies, the regulator, market participants and customers (of all varieties). It is often difficult to comment on some of the key issues such as the capital expenditure programmes without access to commercially confidential information. There is a concern that greater "customer engagement" simply provides superficial legitimacy to the outcome of the price control process which remains to all intents and purposes a negotiation between the network companies and the regulator.

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

Network companies have a legitimate interest in ensuring that consumers can endorse and support the outcome of the price control process. Network companies must ensure that consumers are informed as far as possible during all stages in the development of the price control framework. An explicit allowance in the price control to enable the regulated companies to recover costs associated with consumer engagement is, therefore, not required.

However, is it difficult for consumers to participate fully in the negotiations that take place on the details of the price control since this relates to commercially confidential information. It may be possible for some wider endorsement of the overall objectives or the principles that are adopted by consumers, by the companies and by the regulator. This could be achieved through a programme of engagement with interested groups during the development of the price control (for example through regular workshops on particular topics).

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

The structured approach to defining outputs provides a coherent framework for determining delivery of investment plans, services and defined outcomes. However, it is difficult at the start of the price control period to assess whether these outputs are correct and enduring. The focus on the output established at the start of the price control may lead to inefficient outcomes in the context of the rapidly changing environment in which the network companies operate. For example, the deployment of solar panels at the rate seen over the last five years was not fully envisaged at the time of the last price control.

Sufficient flexibility is required in the price control process to enable adjustments to outputs to reflect key developments in the network companies businesses. As a result of Government policy or market developments there could be significant changes required in desired outcomes. For example, there may be significant deployment of electric vehicles (or limited deployment) that was not envisaged at the time that the price controls were set. An initial output that does not envisage the deployment could restrict the potential for electric vehicles while a measure based on rapid deployment could lead to underutilised investments. It is clear therefore that the changing business environment will provide significant challenges to the long-term price control process and to the network companies.

The RIIO "incentives" and "outputs" regime is based on the assumption that network company revenues are inherently stable and predictable. With hindsight it is not altogether clear that this framework is robust in a changing business environment.

The range of outcomes envisaged in the Future Energy Strategies published by National Grid demonstrates that that network company revenues and capital expenditure could be significantly different over the price control period in different scenarios. The price control regime must reflect the potential range of outcomes for the network company revenues.

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?

We welcome the potential improvements to the outputs framework by including additional categories. These categories should reflect the key drivers of the network business such as "efficient system operation for distribution companies". However it is a difficult to determine at the start of the price control whether the categories will remain robust for the full duration of the price control. It is possible that the focus of the network companies could change over the price control period with greater emphasis on some activities rather than others. For example, the distribution networks face considerable challenges over network constraints that were not envisaged at the time that the price control framework was established.

6. Did the outputs target the right behaviours?

It is clear that the outputs framework is designed to target behaviour by the network companies. It is difficult to determine if this is the "right" behaviour. Since the outputs are set ex ante the network companies have an incentive to deliver them.

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

It is always difficult in a price control that relates to allowed revenue to determine outputs that are not related to direct expenditure in the price control period. However, it is important to focus on the deliverables or the behaviours expected under the price control regime to ensure that the network companies have the correct incentives. These deliverables could be qualitative and assessed through for example customer satisfaction surveys. However, the "difficult to define" outputs should not form a significant part of the price control. Rather the network companies should fulfil the requirements of their relevant licence and deliver services as expected from a reasonable and prudent operator.

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

The output targets and associated financial incentives for RIIO-1 reflect the assumptions and assessments made at the time that they were determined. Essentially customers pay for the outputs determined under this price control, as part of the regulatory agreement with the network companies. In other words customers do not have a choice but must pay for the outcomes under the RIIO-1 price control.

With hindsight the targets and financial incentives for RIIO-1 may be questionable in certain areas. However, the regulatory arrangements determine the recovery of the costs agreed under the ex-ante price control.

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

The RIIO-1 price control approach is based on the ability of the network companies and the regulator to determine efficient outcomes and associated allowed revenues. It will always be difficult to ensure that the outcomes fully reflect the assumptions made at the outset of the price control. Consequently the price control regime may enable the network companies to achieve returns that exceed the assumptions set in the price control.

The price control regime should be sufficiently flexibility to ensure that that network companies cannot achieve what are considered to be excessive returns. Where possible the regulatory arrangements should enable network companies to share any benefits above those envisaged at the time of the price control with customers where they have been legitimately earned (i.e. through the actions (and not the inaction) of the network companies).

As noted in the open letter it is important that the price control process retains the trust of all stakeholders and ensures that network companies can efficiently finance their businesses. It is in the interest of the network companies and the regulator to manage the price control process in a manner that retains the confidence of all stakeholders.

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

With an ex ante price control approach it is difficult to determine the extent to which forecasting errors will influence the relative efficiency of the revenues achieved by the network companies. It is clear that there will be outcomes that are not forecast and these could be considered as errors.

The price control regime is based on a stable and predictable business environment in which the network companies operate. Given future uncertainties it may be appropriate that there is more flexibility in the price control to reflect market changes and to enable the process to adapt to unforeseen changes.

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?

Any question about a "fair" return for the regulated network monopoly companies relates to the risk associated with investing in such a company. Since the risk relates essentially to the price control, then this requires an assessment of the equity risk under the capital asset pricing model. This is associated with a comparison with other sectors and regulated business. The "fair" return is therefore determined by the regulatory regime under which network companies operate in GB. It is important that there is sufficient trust in the regulator to establish an appropriate benchmark return for such relatively low risk businesses.

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?

As noted in the Open Letter the key determinant of the cost of capital is both the environment in which the businesses operate and the stability of the price control regime.

There may need to be more flexibility in the price control regime to reflect the changing business environment is which the network companies will operate over the 8-year price control period. This flexibility may be regarded as increased risk for the businesses, but may also ensure greater possibility to adapt the regime to reflect changing circumstances. The flexibility could include more opportunities for cost sharing with customers or the sharing of potential profits from upsides that were not envisaged at the time the price control was set. This reflects that fact that the network companies' business model may be less stable and predictable than in previous years.

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

The regulator should review the potential for improvement in the methods for indexation of the costs of debt and equity.

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 do not have a view on any specific amendments to any core aspects of financeability that should be considered in light of performance during RIIO-1 and the change in the financial environment. However, the approach to tax, capitalisation rates and depreciation should be reviewed as part of the price control assessment.

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?

We do not have a view on moving to CPIH (or another inflation index). However the approach to indexation should be reviewed as part of the price control assessment.

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

There are merits in aligning the price control regimes for the transmission companies and the distribution companies. In particular there are synergies associated with the price control process (e.g. only one cost of capital assessment is required) while the incentive arrangements and outputs can be aligned. However, there are resource implications from this approach both for the network companies and the regulator.

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

To manage the price control workload for the regulator it is possible that the gas and electricity arrangements could be decoupled. This would reflect the fact that the investment drivers of the gas networks are different to those associated with the electricity networks.

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?

No explicit changes are required to the RIIO framework to enable companies to make full use of smart alternatives. Since the RIIO framework is based on outputs, the companies should have sufficient flexibility to make economic and efficient investments in appropriate technologies required to deliver those outcomes. However there are a number of restrictions that must apply to the network companies as follows:

- The network operators should not procure services that are an alternative to a functioning wholesale market nor should any services that are developed interfere with the efficient working of the wholesale market by supressing price signals;
- Smart solutions that are "balancing services" including frequency, voltage support and inertia (such as synchronous compensation equipment) should not be owned or operated by the network companies;
- Network companies must ensure that smart solutions are compliant with the EU Network Codes including the Electricity Balancing Guidelines and the System Operator Guidelines;
- Smart solutions should be competitively procured by the system operator for the relevant network from market participants. Smart assets owned or operated by incumbent network companies would be in direct competition with other service providers and would undermine market innovation and competition;

- Network operators must facilitate the development of smart solutions by providing a level playing field. This must include robust monitoring of service provision; and

- Network operators must ensure that the customer welfare benefits of smart solutions are transparent and that they can deliver value for money for customers.

It is important that smart solutions are capable of efficient delivery of the relevant service to the network operator. This is particularly relevant in the context of increasing congestion on electricity networks. In this context the role of the distribution network owners as "system operators" requires further evaluation.

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?

The issue of stranded assets relates to the nature of the network companies asset base and the way in which assets are allowed to earn the regulated return. Under the current GB arrangements there is no explicit arrangement that allows specific assets to be included or rejected from the regulated asset base. Rather the arrangements establish a framework for expenditure with some ex post checking to ensure that the expenditure has been efficiently incurred.

Greater ex ante scrutiny of specific asset expenditure and delivery would enable the determination as to whether an asset should be included in the regulated asset base. This may address concerns about inefficient expenditure but could lead to unduly complex and intrusive regulation that more resembles "rate of return" regulated rather the price control approach.

However, the question appears to be based on the assumption that allowed expenditure will include assets that are part of the regulated asset base but are underutilised or no longer needed as a result of a change in the external environment. In this context customers are in effect paying for assets which with the benefit of hindsight are not needed. The nature of the price control process based on specific outputs may result in such assets given that expenditure programmes are determined significantly in advance of delivery.

Given the potential for rapid changes in the electricity market over the price control period it is appropriate that the regime should be flexible enough to facilitate changes in expenditure that reflect the external market environment. The process must ensure that network companies are not locked in to inefficient expenditure programmes. The nature of the adjustments and the process by which they are determined requires careful judgement and may imply greater monitoring during the price control process.

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

We agree that the price control arrangement should include mechanisms that address uncertainties in outcomes, including volume related changes to expenditure, appropriate triggers or thresholds for expenditure and pass through of certain costs that are determined to be outside the network companies' control.

We do not favour an approach based on mid-price control reviews, particularly where this may result in step changes in costs or expenditure that is passed through to customers. Such changes may result in costs that cannot be recovered from customers, particular where they result in unforeseen changes in network company tariffs. In these circumstances it may be appropriate to roll up certain costs that can be recovered in a later 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?

The eight year price control and uncertainty mechanisms must take into account the stability and predictability of network company costs and the volatility of the associated cost recovery mechanism. In this context network companies should be encouraged to provide tariffs for use of the system that are stable and predictable for customers while ensuring efficient cost recovery.

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

We have no comment on the process for assessing company business plans.

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

Clearly historic performance relative to the price control regime should be taken into account in assessing business plans. Network companies that have earned returns significantly in excess of the price control framework may require particular attention.

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

It is clearly important that Ofgem undertake a benchmarking exercise to determine relative efficiencies of the network companies. From this it may be possible to determine the characteristics of an efficient network company. However, we would be concerned if Ofgem were to make significant assumptions about expected efficiency that are not based on assessment of actual company performance. The particular circumstance associated with each network company may also need to be taken into account (for example, there may be significant differences between companies that have a geographically dispersed customer based when compared with a densely populated customer base).

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?

We have no comments on this question.

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?

Network companies acting as prudent operators should provide information revealing efficient costs. Failure to do so could be considered as a breach of licence.

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

We have no comment on this issue.

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

We cannot comment on this issue.

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

The incentives inherent under the RIIO model have certainly encouraged the network companies to undertake certain activities (that is the nature of the incentive regime). It is difficult to determine if this is "more innovative" than would otherwise been the case since the activity is linked to the incentive. Delivering greater innovation and initiative from network companies would require a step change in corporate culture. However, in this context the price control regime has the potential to restrict innovation rather than encourage new initiatives.

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

We have no comments on this issue.

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

We note that there is considerable information asymmetry between market participants, customers, the regulator and the network companies in the price control process. Therefore it is difficult to determine the relative complexity of the price control regime. However, it is clear that the outcome should be a set of well understood and transparent arrangements.

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

We have no comments on this issue.

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

It is clear that network companies will revise their regulatory business plans from time to time in a manner that reflects the external environment in which they operate. The regulator may wish to scrutinise such revised business plans. It is not clear, however the extent to which the revised business plans should impact on the regulatory asset base and the allowed revenue under the price control. Increase divergence between business plans may however be used as a trigger to instigate further investigation of the reasons for the deviation.

There is a trade-off between the stability and predictability of revenues (reflected in network company tariffs) and the possibility of adjustments to engineer more efficient outcomes. We are concerned that any adjustments that increase volatility of network tariffs.

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

We have no comments on this issue.

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

We have no comments on this issue.

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?

The changing role of the SO and its separation from the associated GBTSO requires careful consideration in the RIIO framework. The GB electricity SO should have a separate price control that better reflects the SO specific objectives.

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

We support the broader stakeholder engagement approach.