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Storengy UK answer to Ofgem's Open Letter on the RIIO-2 Framework

Dear Jonathan,

Storengy UK welcomes the opportunity to comment on Ofgem's Open Letter on the RIIO-2 Framework.

The RIIO Framework sets the level of a significant share of the GB energy industry cost, which is paid by end consumers. It furthermore contributes to shape the market through the ensuing cost allocation, with potentially large impacts on end users and connected parties. Storengy UK, owner and operator of one of the largest natural gas storage in GB, wishes to share its views on the next regulatory period.

The guiding principle should be to ensure that the consumers pay the right price for the use of the networks. In light of declining transported energy volumes, investments should be avoided when there is no absolute certainty they will required over their asset-life. It is important to keep in mind that the cost recovery of the allowed revenue will be borne by a decreasing quantity of energy, due to increased demand efficiency, off-grid generation & consumption. Any growth in the asset base will have long lasting effects on network tariffs, while the growing uncertainty on flows means they may become redundant assets in the future, hence regulation must ensure investment in the monopoly networks is by exception rather than the default option.

GB has many merchant assets connected to its networks, which are well positioned to tackle potential shortfalls of the system on a commercial basis. These commercial arrangements would provide energy infrastructure assets, struggling to make a profit in the current market design, with an opportunity to provide system ancillary services. For example the provision of intraday gas flexibility services, currently a monopoly activity undertaken by grid mainly through linepack, could be open up to competition. This in turn would facilitate a least cost solution for the end customer, avoiding unnecessary new investment by Grid.[1]

You will find below our answer to selected questions. We remain available if you require any clarification.

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

Storengy UK agree with the stated objective "*RIIO-2 will ensure regulated network companies deliver the value for money services that consumers want and need".* We note that defining value for money is challenging in an environment where future energy requirements are not known. This is why we stress the importance of favouring commercially based solutions over investments in the network wherever it is possible, as the later would feed into the price consumers pay for a very long time. Furthermore, commercial solutions typically have a shorter implementation time, and decisions can be more easily reversed.

We fully support Ofgem's view that in an energy system, which is evolving, "*network companies should utilise flexible, non-traditional options where appropriate (e.g. purchase of flexibility services, such as storage or demand-side response services, to manage network constraints*)". A greater involvement of all stakeholders, not only the network companies, in providing the delivery of the required services, would maximise the level of efficiency and stimulate innovation by fostering competition.

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

The definition of outputs is very helpful to provide a clear view of what is required in each area. However, the definition of Network Output measures (NOMs) only once at the start of a price control period restricts the ability to react to market changes. There has been several instances in the current RIIO-1 price control, for example in gas transmission, where the rationale behind the NOMs has fundamentally changed over time (Avonmouth pipeline, Fleetwood entry point). In our view, this reflects the uncertainty around the actual need for network reinforcement amid declining demand.

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?

Considering the lower volumes and the challenges brought by the energy transition, with a potentially less centralized energy system, we think an output should be added to address the longer-term sustainability of the value for money provided by regulated monopolies. There is at present no feedback loop to correct

[1] Indeed we would argue that there is a "missing market" for system flexibility provision in the gas market today, and this is an area where demand is set to grow significantly as CCGT acts as backup in the power market.

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the growing discrepancy between the growing Regulated Asset Bases (RAB) and the lower volumes that attract charging.

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?**

Storengy UK reminds that regulated monopolies are by nature activities with less risk for the investor compared to merchant activities. The fact investors accept lower returns on this asset class is confirmed by the premium on RAB observed when of some of these assets were sold.

While it may not be possible to assess what a fair return is, we think that a market where regulated business returns outperform over the long term the returns of the rest of the industry operating in the competitive field is not sustainable. It may effectively channel capital to the monopoly network companies at the expense of the companies with a higher risk profile.
We consider the attractiveness of both the competitive and the regulated energy sectors should remain balanced for investors. If capital ends up being invested in the energy market only when returns are underwritten by the end-consumer, this would be detrimental to the competition and to the take-up of innovation.

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?**

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 use of a totex approach has already reduced the bias towards capex solutions. However, we think new capex in networks should be further dis-incentivised given the uncertainty of the future flows in the energy system, and the declining energy demand. At the moment, the growth of the Regulated Asset Base is still incentivised over opex solutions, in cases where the later look more expensive in the short term. We propose to include to the comparison capex vs opex solution a measure of the uncertainty of the relevance of an investment in the long term.

An alternative market based solution, even if slightly more expensive than the capex solution, comes with the option of ceasing it and removing the associated cost when needed, in a much more effective way than having to deal with a stranded asset. For example, one way to weigh in the uncertainties around the capex option would be to use a factor to convert capex to opex allowances, to compare NPVs of capex and alternative opex-based solutions with different discount rates, or to restrict NPV calculations to a much shorter time horizon.

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

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As explained in part 5, we wish the evolution of the Regulated Asset Base, which feeds into the Allowed TO Revenue, to be more closely aligned with the underlying GB energy demand. The discrepancy between gas demand growth and TO Revenue growth, which can be observed over the RIIO-T1 Price control period, eventually leads to significant increases in the transmission component of the consumer price.

As the volume of transported energy decreases, mechanism that allow revenue to vary should be explored. In the absence of incentive, the cost burden of using the network for remaining consumers and connected parties relying on centralized network will grow, as the energy gets increasingly produced and consumed off grid (in the case of electricity) or tempted to by-pass the GB to access directly European markets on the continent (in the case of gas). The RIIO-2 should recognise the reality of declining energy demand, and ensure the creation a stable framework that does not systemically report the cost of revenue recovery on an ever-decreasing number of consumers.

Such mechanism would give the network monopolies a strong incentive in maintaining the strong position of the GB energy market relative to its neighbours, which would be positive for the security of supply.

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

Storengy recognizes the need to have a long-term stable framework in order to invest. However, it must be acknowledged that few businesses currently enjoy visibility for a period of 8 years. We consider it would be more appropriate to have regulation periods in line with investment cycles in the market of 3 to 4 years.

A regulatory period of 4 years would enable more agility in adapting to the market environment than embedding in the regulatory framework complex mechanisms intended to address uncertainty. In the UK, the regulatory regime is well established and trusted, so we think investors are unlikely to be deterred by shorter regulatory periods.

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

Storengy UK considers that stakeholders should be more involved in the high level decision on how to allocate expenditures for each Network Output measures. For example, looking back at a recent decision on gas transmission, there was significant value for money when Ofgem decided to reduce the capacity obligation at Fleetwood, generating infrastructure capex savings of £277.5m while still delivering the required output.

In the case of gas transmission, there is already a good level of transparency provided by NGGT through the Gas 10-year statement. We would welcome additional clarity on the costs of any significant capex development (threshold to be defined) and their alternative opex solutions. Before capex are decided, stakeholders should be submitted with the investment case and offered the possibility to propose alternative solutions, for example through a consultation process. We believe giving more room to

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competition could foster constructive discussions among stakeholders and provide innovation stimulus and efficiency.

Sincerely,

Benoit Enault

Head of Business Development, Commercial and Business Services

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