



Rebecca Barnett
Interim Director of Networks, Ofgem

19 October 2022

Dear Rebecca,

S&C response to Open Letter on the next network price control review process

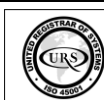
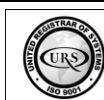
We welcome the opportunity to respond to Ofgem's Open Letter on the next network price control review process. We consider that it is important to consider the lessons learnt from the current round of price controls and the broad range of changes impacting both the networks and the wider energy system in developing an updated approach for the next price controls reviews. However, we have some concerns with this process being started before Final Determinations have been published for RIIO-ED2, as there is still more to be learnt from that process, and Ofgem has not provided clarity on the specific elements that it considers are working well and those that are working less well in the current RIIO arrangements.

We broadly agree with the range of strategic issues in the energy system that Ofgem has set out but would also highlight the growing importance of reliability and resilience as key foundations for ensuring that customers benefits are maximised from the energy transition.

We agree that there is a case for change in terms of ongoing refinement of the RIIO-2 framework to address issues such as the penetration of distributed generation, greater levels of uncertainty in demand and generation, and the electrification of transport and heat, as well as changes in the overall energy mix. For example, the mix of outcomes that are incentivised may need to change with the potential for a greater focus on DSO activities and flexibility markets. However, we don't consider that a more fundamental shift away from RIIO is needed.

At its heart, RIIO is a flexible approach to network regulation which is built on the pillars of strong incentives for efficiency, a totex approach which provides flexibility between opex and capex type solutions, a strong focus on outcomes and associated incentives, and support for the innovation needed for the energy transition. A continued focus on outcomes and associated incentives well as efficiency and innovation seems the right approach. To move away from this would appear a retrograde step with potentially negative consequences for the ability to meet the challenges posed by the energy transition.

RIIO is recognized internationally as one of most advanced forms of performance-based regulation. There are numerous examples of countries adopting aspects of the RIIO arrangements as a way of addressing the challenges associated with climate change and decarbonisation such as: the use of uncertainty mechanisms or off-ramps in Ontario to address change; Italy's adoption of the totex approach; Illinois moving to a broader range of outcome metrics; and a range of jurisdictions adopting innovation support mechanism either through revenue allowances or through competition. It would





therefore seem odd for Ofgem to move away from RIIO at a time that it's seen as effective and the leading form of PBR elsewhere.

A recent report and article by the Rocky Mountain Institute (RMI)¹ in the U.S. recognises the benefits of the RIIO framework and in particular advocates for the adoption of a totex approach in the U.S. to help ensure affordability through the energy system transition.

We also question the suggested high-level alternative options for the development of an updated framework. All options were considered extensively as part of the RPI-X@20 review and then subsequently as part of the development of the RIIO framework. Therefore, none of those highlighted really represents new thinking. These all have some inherent weaknesses and the positive elements of them such as negotiated settlement for elements of business plans can be captured through refinement of the existing RIIO framework.

For example, an alternative ex-ante regime, with a simpler target to improve opex efficiency, would represent a step back to early RPI-X price controls. Such an approach would not address potential capex-opex trade-offs or create an appropriate balance between expenditure and other outcomes that will be critical for the future energy system.

The issues with ex-post regulatory arrangements have been seen in Ofgem's application of ex-post reviews in the past. They raise stronger information asymmetry issues between network companies and Ofgem than ex-ante incentive-based arrangements which have been demonstrated to be effective in revealing information over time.

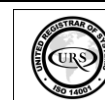
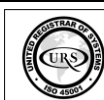
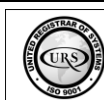
We've set out some further information in our responses to Ofgem's consultation questions in the Appendix to this letter.

Please do not hesitate to contact me if you have any queries on this letter or wish to discuss any elements of it.

Yours sincerely,

Chris Watts
Director – Regulatory Affairs

¹ <https://rmi.org/totex-ratemaking/>





Annex 1 – S&C Answers to Ofgem questions

Question 1: Do you have any views on the strategic issues we must consider in the development of the next price control review process?

We broadly agree with Ofgem's view on the key strategic issues that should be considered including:

- the accelerated increase in offshore wind capacity and proposed new nuclear capacity requiring additions to the electricity transmission networks.
- distribution networks needing to manage increases in renewable generation and increases in demand from the electrification of transport and heat.
- uncertainties stemming from the reduction in gas demand and the potential use of hydrogen.
- the use of energy storage on the system.
- changes to the operation of the electricity system including the use of flexible resources from DERs, demand-side response, and energy efficiency.
- the proposed independent Future System Operator, and
- a range of geopolitical issues.

One issue that is not highlighted is the importance of continuing to improve reliability and resilience to address growing system threats including those from climate change and to ensure that benefits are fully realised from the energy system transition. As part of this, a focus on equity and the needs of vulnerable customers will continue to be essential to ensure all customers can benefit from the energy transition.

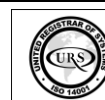
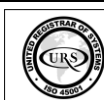
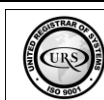
Question 2: Do you have any views on the case for change we have outlined?

We agree that there is a good case for change in terms of ongoing refinement of the RIIO-2 framework to address issues such as greater levels of uncertainty in demand and generation, and the electrification of transport and heat etc. For example, the mix of outcomes that are incentivised may need to change with the potential for a greater focus on DSO activities and flexibility markets. However, we don't consider a more fundamental change away from the RIIO framework is needed.

As highlighted above, RIIO is a flexible approach to network regulation which is built on the pillars of strong incentives for efficiency, a totex approach which provides flexibility between opex and capex type solutions, a strong focus on outcomes and associated incentives, and support for innovation needed for the energy transition. A continued focus on outcomes and associated incentives, innovation and total expenditure seems right.

Areas where we consider that it is important to continue to refine the RIIO framework include:

- the continued development of uncertainty mechanisms to ensure they are as agile as possible and take on board customer and stakeholder input including uncertainty mechanisms for strategic distribution investment and large transmission projects.
- reviewing the balance of outcome metrics and incentives over time including giving greater weight to other aspects of reliability and resilience such as short interruptions where there has been a deterioration in performance over time, DSO activities, and the use of flexibility services, and
- the role of future stakeholder engagement including options for elements of negotiated settlement.





Question 3: Do you have views on whether the changes to the electricity or gas sectors mean that there is a case to consider alternatives to the approach taken in the RIIO-2 price control?

As noted above, we don't consider that there is a strong enough case for adopting a completely new regulatory framework but there may be elements of the alternatives which could be brought into the RIIO framework to ensure it can best meet the future challenges for the gas and electricity sectors.

Question 4: Are there any broad frameworks or options that you think we should consider, including variants and alternatives to those we set out?

We consider that there are weaknesses with each of the alternative options to RIIO that are set out by Ofgem in its Open Letter. We address each of these in turn below:

1. An alternative simplified ex-ante incentive regime, based on a target to improve operating efficiency.

This would essentially be a move back to the early RPI-X price controls where the 'X' terms were based on an assessment of the scope for long-term productivity savings for opex. This would effectively roll back much of the learning from successive price controls by Ofgem and others such as:

- the need for totex incentives so that network companies can optimise across opex and capex, rather than creating perverse incentives for capex solutions
- the need for outcome-based incentives to ensure that companies drive efficiency by optimising across expenditure and other aspects of performance
- the use of uncertainty mechanisms to address rapid changes and requirements, and
- innovation mechanisms to ensure that effective R&D isn't crowded out by the drive for efficiency.

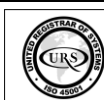
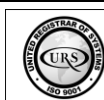
2. A model involving greater user/stakeholder participation to determine investment need or other elements of the price control.

There has been a natural move in this direction as part of both Ofgem's Enhanced Customer and Stakeholder Engagement Process for RIIO-ED2 and as part of the NewReg² process for AusNet in Australia. However, while elements of the price control could be settled through this process, there are also likely to be limitations as such groups of representatives are likely to have greater information asymmetries with the network companies than Ofgem. Ultimately, Ofgem will always be in a better position to carry out comparative analysis across companies to set price controls.

3. An ex-post regime, where allowances are based on a pre-determined rate of return, subject to operational delivery.

There are significant risks associated with a shift towards an ex-post regime as there are likely to be stronger information asymmetries between Ofgem and the network companies. This has been highlighted by the limited adjustments that Ofgem has been able to make for cost inefficiencies in ex-post expenditure reviews in the past.

² [New Reg | Australian Energy Regulator \(aer.gov.au\)](https://www.aer.gov.au)





Further, the idea that incentives will be primarily focused on achieving whole system doesn't seem balanced. While whole system thinking and activities are very important for the ongoing development of the future energy system there are a much broader range outcomes that are also important such as a focus on safety, reliability, resilience, efficiency etc.

Overall position

We understand Ofgem's desire to ensure it has the right regulatory framework in place to meet the challenges and opportunities that lay ahead. However, rather than considering options which would represent a fundamental shift away from RIIO, we think the key question Ofgem should focus on is - where are there weaknesses in the existing arrangements and how should the RIIO framework be refined to address those weaknesses? Only by doing so can Ofgem ensure the regulatory framework best meets the future needs of the energy system and, more importantly, the needs of the future customer. To do otherwise risks losing many of the significant strengths of RIIO which have led so many other jurisdictions to follow Ofgem's lead.