



Future Systems and Network Regulation

UKERC Open Letter Response

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Introduction to UKERC

The UK Energy Research Centre (UKERC) carries out world-class, interdisciplinary research into sustainable future energy systems.

It is a focal point of UK energy research and a gateway between the UK and the international energy research communities.

Our whole systems research informs UK policy development and research strategy.

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To Whom it may Concern,

We welcome this opportunity to comment on the future of network regulation and we agree with the strategic issues identified in the open letter. As noted in the letter, the upcoming years are likely to be characterised by disruptive change, both in relation to technological innovation and the governance of the energy system. We note also that broader economic uncertainties are likely to present additional challenges; a coherent and flexible regulatory framework will be crucial in ensuring that the path towards net zero is pursued at an affordable cost to consumers, whilst ensuring that the financial stability of the sector is maintained during a period of rising interest rates and financial market volatility.

As in each question there are overlaps between the answers, rather than comment on each question individually, we briefly outline a number of key areas we consider need to be addressed in the future of energy network regulation:

1. Clarity is needed as soon as possible from government and Ofgem on the future governance direction of the energy system networks. In the absence of this, it is difficult to comment on the future of regulation as a number of crucial questions have been left unresolved: Is the UK Government still committed to the establishment of the Future System Operator and what will its precise remit be? Will there be regional DSOs, a separate independent distribution market operator, a regional planner? Regulatory frameworks for the next price control review will be highly dependent on the governance frameworks chosen for both transmission and distribution, and coupling between electricity and natural gas and beyond to other sectors.
2. We understand that choosing a particular price control period can be challenging. Moving from an 8-year to 5-year price control period was welcomed as it acknowledged that transitional change can happen quickly. However, there is also the possibility that this may encourage short term thinking. We suggest keeping the shorter price control but requiring companies to produce a longer-term plan (similar to those adopted by the water companies¹) to show how current investments will benefit longer term targets based on modelling from their distribution future energy scenarios, benefitting both investors (through providing some certainty) and coordination between the sectors.
3. RIIO2 allowed for flexibility through the introduction of processes such as volume drivers, re-openers and price control deliverables (and is theoretically welcomed), but the costs and benefits of these processes will not become apparent until they have been activated in the current price control. However, this also provides an opportunity for learning-by-doing through assessment over the RIIO2 period, with the possibility of those successful processes carried forward to the next regulatory review.
4. Further flexibility was incorporated into the RIIO2 framework through the use of sector specific methodologies, giving RIIO2 the scope to introduce additional incentives relevant to the particular industry, and using bespoke incentives which recognised the place-based nature of some decarbonisation

¹ <https://www.ofwat.gov.uk/regulated-companies/resilience-in-the-round/water-resource-planning/>

solutions. We suggest continuing the use of sector specific methodologies alongside the common framework but with more emphasis on whole system outcomes to meet net zero.

5. Due to the large number of output incentives in the recent price controls, there has been a tendency for companies to chase incentives rather than focussing on improving outcomes for customers. We agree with recommendations from the Taskforce on Innovation, Growth and Regulatory Reform² on regulation that focusses more on outcomes. We suggest rather than the use of multiple output incentives, Ofgem should consider a more principles-based approach, where an overarching goal of delivering best value for customers would operate within an outcome framework with net zero at its centre, rather than meeting particular outputs.
6. A major challenge for Ofgem is the need to encompass not only economic regulation, but also to understand the technical requirements of a transitioning system, whilst assessing the social and environmental outcomes of investments to ensure that net zero targets are met. The continuation of the Customer Engagement Groups (CEGs) and the Challenge Group could allow Ofgem to relinquish some of its decision-making by trusting the diverse knowledge within the CEGs and Challenge Group. As in RIIO2, the ability of the groups both to challenge the validity of business plan investments and to express support where they feel customers' and other stakeholders' needs have been appropriately recognised, should enable Ofgem to concentrate on the areas of its expertise, that of economic appraisal.

This Open Letter raises some fundamental questions about the regulatory approach. Should a move away from the RIIO model and incentive regulation more generally be considered, a review of options will be required. Similar to the RPI-X@20 process, such a review ought to be transparent and incorporate independent, external expertise. A review of the regulatory approach from first principles could take the net zero target as its starting point and would need to take into account Ofgem's existing remit and its strategic vision. We realise this would need a mandate from the Secretary of State and that time and resourcing may be an issue. However, as mentioned in our response to the 'Future of local energy institutions and governance call for input'³, clarifying future roles and responsibilities via expected timelines and milestones can create certainty and help to reduce risk.

As we move into the next transitional phase, we recognise the difficulties of a one-size-fits-all approach to network regulation. Transmission and distribution, gas and electricity, all face very different challenges in meeting common societal objectives. This type of integrated 'whole systems' thinking is a key competence of the UK Energy Research Centre and we are keen to engage with Ofgem during this process of updating the regulatory framework around energy networks (see examples of ongoing research efforts)^{4,5}. We hope that the points highlighted may initiate a

²https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/994125/FINAL_TIGRR_REPORT__1_.pdf

³ <https://ukerc.ac.uk/publications/ofgem-call-for-input-future-of-local-energy-institutions-and-governance/>

⁴ <https://ukerc.ac.uk/publications/ten-years-of-customer-engagement/>

⁵ <https://ukerc.ac.uk/news/costs-and-benefits-of-infrastructure-investment/>

conversation about how these processes and incentives are designed and we are happy to expand on the points raised.

Sincerely,

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