

Energy UK response to Ofgem's Open Letter on Future Systems and Network Regulation

31 October 2022

About Energy UK

Energy UK is the trade association for the energy industry with over 100 members - from established FTSE 100 companies right through to new, growing suppliers, generators and service providers across energy, transport, heat and technology.

We represent the majority of the energy sector - excluding networks and upstream oil and gas.

Our members deliver nearly 80% of the UK's power generation and over 95% of the energy supply for 28 million UK homes as well as businesses.

Energy UK welcomes Ofgem's early engagement on the future regulation of networks: the energy system must change rapidly to meet government and industry net zero targets over the coming decades, and network price controls are a key component to enabling that transition. We look forward to engaging further in the new year.

Headline points

- Ofgem must recognise that infrastructure needs to be delivered at an unprecedented scale and pace, whilst also embracing new technology and facilitating innovation. Network regulation must be adapted to enable this, which will include changes to allowances and incentives, and taking whole-systems benefits into account.
- Energy UK agrees with the principles of the network price controls: offering incentives to deliver innovation and outputs. However, the regulator, network companies and other key influencers (e.g. Government and ESO/FSO) need to adapt the regulatory frameworks surrounding delivery to be more open and flexible, and allow for the necessary scale and pace of change.
- The volume of infrastructure that must be delivered requires a level of certainty to minimise the cost of capital for network companies. It is vital that any future network regulation strikes the right balance between change and certainty.
- Wholesale change to the RIIO process could create more uncertainty and undermine investor confidence, leading to a higher cost of capital and delayed investment in net zero infrastructure. As such, we recommend evolution of the current RIIO process to address the identified strategic issues. The immediate focus should be on delivery of a set of principles under which the framework should deliver, recognising key targets set by government and

the need for rapid delivery against these. This has the further benefit of not placing pressure to deliver an entirely new mechanism on an already-constrained Ofgem.

- We also note that the price control framework on its own will not be enough to support the energy transition, it must be delivered alongside other regulatory reform such as reform of the connections regime and of the planning regime for onshore and offshore wind and transmission infrastructure.

Questions

Do you have any views on the strategic issues we will face in the development of the next price control review process?

- Energy UK broadly agrees with the strategic issues identified in the letter. Whole-system optimisation will be of particular importance when considering new price controls due to the increasing development of Distribution System Operation functions and how these will integrate with the role of the Future System Operator (FSO), with overlapping incentives. The FSO will also have a strategic role across both electricity and gas, as well as the nascent hydrogen sector. As such, involvement of the FSO will be important when considering whole-systems outcomes of the price control process.
- Another area for consideration is the increasingly complex demands for connections and timely upgrades to the grid, as well as the need for anticipatory investment in network infrastructure. This requires recognition of the fundamental shifts in the approach taken to network delivery, including adopting innovative approaches and delivery models, the use of new technologies, the need for flexibility to re-prioritise based on system needs, and wider increasing digitisation across UK energy networks.
- Further considerations for the future of networks include:
 - An increasing need to adapt grid infrastructure to severe weather events, such as extreme heat, cold, storms and flooding.
 - Decarbonisation of their own activities, for example moving away from the use of SF₆.
 - The need for greater access to data and increased digitisation of processes, and the opportunities this presents.
- Along with natural gas and hydrogen, which could include parts of the gas system re-purposed whilst ensuring continued security of supply, it will also be important to consider the treatment of carbon capture and CO₂ networks under future regulation.
- A final area of uncertainty that should be considered is the future of network charging and any changes that result from REMA, which creates an unpredictable investment environment. Uncertainty around the future of network charging has been exacerbated by the suspension of the TNUOS Charging Task Force. Energy UK would welcome Ofgem considering the longer-term structure of transmission charging and how this fits with the objectives of REMA, the net zero transition, and the RIIO framework.

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

- Energy UK largely agrees with the outlined case for change, in particular, that the current process is resource-intensive and favours those parties with more capacity for engagement. This issue persists throughout the RIIO and Business Plan processes, as well as during each period through Re-openers and Uncertainty Mechanisms, through engagement with both Ofgem and the network companies.

- Whilst network regulation is a necessarily complicated process, there are a number of areas that could be improved. For example, there is a high degree of variation between DNO business plan reporting and calculation of metrics, which makes comparison difficult. Consistency would make this process easier to engage with.
- Energy UK welcomes the stakeholder engagement efforts of the Network Operators. However, such engagement needs to be tackled with care, to give a strong voice to stakeholders and enhance network outputs. In addition, more targeted engagement, focussed on specific stakeholder groups could provide more useful actionable outcomes, with a greater degree of involvement.

Do you have views on whether the changes to the electricity or gas sectors mean we should consider alternatives to the approach taken in the RIIO-2 price control?

- Energy UK does not believe that now is the time to consider implementing an alternative to the current RIIO process. Rather, the industry and customers would be better served by the RIIO-3 timetable being known and agreed as soon as possible.
- This step would help avoid the issue of stop/start investment cycles, boost certainty and allow network companies to begin developing their business plans. This is vital given the certainty over future transmission network investment needs through the Holistic Network Design and Networks Options Assessment processes.
- There is a need for evolution of the existing processes and frameworks ahead of the RIIO-3 period in line with wider regulatory improvements, for example in planning arrangements. Beyond this, more significant changes will be needed, which may involve the need for different treatment of gas networks compared to electricity, given the uncertainty around the future of gas demand. For example, there may be a future in which there is little need for much expansion of the gas network, which may lead to stranded assets and inefficient cost recovery through the RIIO methodology. In this case, it may be worth considering a return to a Regulated Asset Base view on the gas side, decoupled from the approach taken to electricity networks, for which the future needs case is clearer. However, this will also depend on the approach taken to regulation of hydrogen networks.

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

- It is important to consider that developing the network at least cost in the short-term is not necessarily the same as a least-regret long-term option, which considers a larger range of benefits, including social benefits. Future price controls must allow networks and their users to innovate, and facilitate both flexibility and anticipatory infrastructure investment given the significant volume of change expected in the next decade. This could be delivered through reform of the current price control process. However, in order for Ofgem to provide this broad oversight, we would welcome a review of its objectives and statutory duties, including setting out the principles of what future price controls are aiming to achieve.
- In providing a well-informed, holistic view of the network, the FSO will play an important role in network regulation in the future, including providing a 'needs case' for projects through work such as HND. Option 3 in the letter could complement a reformed RIIO process, with FSO supporting Ofgem by providing appropriate checks and balances to the network companies, to encourage a better balance between increased network capacity and greater use of flexibility. We would welcome any clarity on the FSO and its roles and responsibilities, including how it interacts with Ofgem, as early as possible.

- Finally, it should be considered that different options might be appropriate for different types of investment. For example, costs could be recuperated differently for new projects than they are for management of existing assets.