

The Office of Gas and Electricity Markets
10 South Colonnade,
Canary Wharf,
London,
E14 4PU

Sent via email to:
FutureNetworkRegulation@Ofgem.co.uk

31 October 2022

Dear Sir/Madam,

Energy Networks Association Response to Ofgem's Open Letter on the next price control review process

Energy Networks Association (ENA) represents the owners and operators of licenses for the transmission and/or distribution of energy in the UK and Ireland. Our members control and maintain the critical national infrastructure that delivers these vital services into customers' homes and businesses.

ENA's overriding goals are to promote UK and Ireland energy networks ensuring our networks are the safest, most reliable, most efficient and sustainable in the world. We influence decision-makers on issues that are important to our members.

These include:

- Regulation and the wider representation in UK, Ireland and the rest of Europe
- Cost-efficient engineering services and related businesses for the benefit of members
- Safety, health and environment across the gas and electricity industries
- The development and deployment of smart technology
- Innovation strategy, reporting and collaboration in GB

As the voice of the energy networks sector, ENA acts as a strategic focus and channel of communication for the industry. We promote interests and good standing of the industry and provide a forum of discussion among company

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members. This document sets out our response to the Open Letter¹. Some of our members will be providing their own company specific responses.

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

We broadly agree with the strategic issues set out in the Open Letter, whilst noting the following additional points:

Price control decisions since the introduction of the RIIO framework in 2013 have been in a (a) low-inflationary period with (b) low interest rates, at a time when (c) network reinforcement has largely been limited during a period when the GB energy market was in the ‘foothills’ of decarbonisation. In both the medium and long-term future, all three of these things can be expected to change due to wider circumstances. In short, greater quantities of capital will be required, at higher cost than in the last ten years, in order to keep pace with public demand for decarbonised technologies.

Any future price control framework will therefore need to move away from the current short-term focus on immediate energy bill impacts and should seek to unlock strategic investments across whole-system (gas and electricity networks), that ensures networks play a transformational role, delivers longer term benefits to the bill payer and economic growth, in a way that is equitable and ensures inter-generational fairness.

Most importantly of all, the value of long term investment is reliant on long-term clarity about the strategic direction of network infrastructure plans. Energy network planning and political decision-making, both national and potentially local, about, for example, hydrogen for heat will be of fundamental importance for the evaluation of network investment. Price control arrangements will have to be adjusted as and when these decisions are made.

Because the quantities of capital required will increase and the economic circumstances in which that capital is raised will result in higher costs, there is a greater need to ensure both stability and transparency in our price control

¹ The views of National Grid ESO (NGESO) and Cadent are not represented and these companies will be submitting a separate response.

framework. Network operators will need to maintain the ability to attract that capital whilst avoiding unnecessary costs caused by the heightened risk associated with a major change to the framework. Transparency, predictability, and simplicity must be central to any future framework to ensure networks can deliver the strategic investment needed at pace, to support both the UK's net zero ambitions and energy independence in the longer term.

An evolutionary, rather than a revolutionary, approach to RIIO, which builds on its track record to date and reflects the price control's strengths as being both flexible but also understood by investors, is essential in the near to mid-term.

A whole-system approach to the design, investment in and operation of our energy system is necessary to reflect the reality that the low carbon technologies that will be used in coming years will operate across the traditional regulatory and operational boundaries that exist, as well with other parts of the energy market. All of the strategic issues set out in the Open Letter including the questions of storage, capital investment and system flexibility will need to be addressed through the prism of a whole-system approach.

This, over time, will require changes to the building blocks of our energy system. Future price controls must of course reflect that change but also that the investment required to reach net zero requires a degree of regulatory stability. Regulatory change must be clearly planned, consultative, transparent and delivered over a period of time.

The reality is that a series of major Government policy decisions about the long-term future of the energy system will be made in the next decade, with some sectors being clearer now than others. Price control funded network innovation projects are already playing a vital role in providing the evidence base for those decisions. Making major changes to the price control system whilst those policy decisions are being made risks creating a 'double whammy' of uncertainty for investors.

The framework must continue to recognise the role of Gas Networks in providing critical resilience today, but most importantly, it will also need to unlock the transformative role that Gas Networks can play in facilitating the growth of Hydrogen through the transition to net zero in a way that also

supports both the energy independence and economic growth agenda set out in the UK Government's British Energy Security Strategy and therefore, Hydrogen network requirements must be part of the framework.

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

We recognise that a central element of good regulation is the evolution of regulatory frameworks consistent with the changing, including policy, environment in which they are applied.

We also recognise, as per our response to Question 1 that our energy system will substantially change over the coming years and decades as existing and new technologies are developed and deployed as we continue our transition to a net zero carbon economy.

Therefore, the need to make changes over time is fundamental to ensuring that policy, regulatory frameworks and the institutional structures that underpin this transition are fit for purpose. But this also needs to be done in a way that is consistent with ensuring investor and stakeholder confidence and the avoidance of creating perceptions of uncertainty in the minds of investors, that would increase the returns investors demand to finance new investment.

In addition, in considering any case for change we should also be guided by core principles of good regulation which are to protect the interests of consumers in respect of the availability, price and quality of service and to ensure that the regulated companies can finance their functions.

Implicit to this is clarity at the outset of the objectives that any change is seeking to achieve, the options available for achieving the objectives and the relative strengths and weakness of different approaches, with this supported by sound evidence wherever possible. Overall, and before proceeding with any change, there must be a significant degree of confidence that any change will deliver a better outcome; not just specific to its particular focus but overall. However, the Open Letter provides little or no evidence to support some of the assertions it makes under this section.

RIIO

The RIIO framework, with its focus on incentives, innovation and outputs, has delivered a significant step change for consumers. Evidence from networks reporting to Ofgem shows that companies are continuing to rise to the challenges of fully facilitating the transition to a secure net zero energy system and that the framework is enabling networks to deliver the intentions behind RIIO.

In addition to continuing to deliver these improvements, RIIO2 has evolved in response to the need to set a framework that facilitates and supports efficient and timely investment and drives the behaviours (including the functions and related activities by energy networks) needed to deliver outcomes consistent with wider policy goals and the interests of consumers. New approaches developed as part of RIIO2 enable investment and its delivery to be shaped and flexed in response to uncertainty and change and for it to be delivered in a coordinated way across companies and sectors consistent with a whole-system approach. We therefore believe the best approach is to refine and build on the range of options available in the RIIO toolkit. Complementary to this is to consider the periods of future price controls.

On the specific points raised in the letter:

Process: We agree that the current process is overly resource intensive and that this is an area that needs to be explored with a view to improving. We believe that there remains significant scope for simplifying the setting and administration of the process (see further comment below).

Structure and Form: The challenges set to face electricity and gas are quite different over the coming period, so different approaches may be needed across sectors. A sector focus is not therefore necessarily a weakness in itself and there will not be a 'one size fits all' solution as the pathways to secure decarbonisation across the different parts of the energy system will be very different. This can therefore be seen as a strength, albeit that these should be complementary with overall coherence from a whole-system perspective.

Periodic Review Process: All large infrastructure investment (i.e. private sector, including monopoly providers and public sector e.g. HS2), due to its nature requires decisions to be made based on the information available at the time decisions are taken to invest. The allocation of risk will always be a major factor in the level of return required by investors and the costs that are ultimately borne by the consumer. It is not clear why an ex-ante approach together with appropriate incentives for efficient delivery might not continue to offer the best approach.

Creation of FSO: We acknowledge the creation of FSO and the activities that it is envisaged it will carry out. In terms of any approach for investment coming forward outwith the price control we would point to our comments above.

Types of uncertainties: It is accepted that uncertainties do vary across sectors. For example, the pathway for electricity transmission investment is clearer. The publication of the HND and NOA refresh, to be followed up by the HND FUE in 2023 means that there is a high degree of certainty on the need for investment. For example, the recent Accelerating Strategic Transmission Investment (ASTI) consultation, has shown that this type of strategic collaborative approach between industry, government and the regulator, coupled with faster decision making, can lead to significant benefits for consumers.

In conclusion on this question, the RIIO framework has driven considerable consumer benefits, with many aspects continuing to be fit for the future.

However, we recognise that refinements are needed to ensure the process to manage uncertainty delivers optimal outcomes for consumers today and tomorrow at the pace needed, whilst being flexible and agile.

The nature of the investment involved, associated timelines and asset lifetimes, along with the need to maintain investor confidence in the overarching regulatory regime makes it essential to allow adequate time to reflect any change to the framework.

Question 3: 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?

We broadly agree that the consideration of any future change to the regulatory framework is not binary i.e. to retain in its entirety or to move away to something completely new. As previously described the RIIO framework has at its core features that are fundamental to and have proven effective in delivering a significant step change for consumers consistent with government's policy aims. We refer you to our response to Question 2 and the fundamental regulatory principles it sets out.

Again, we acknowledge the points set out in respect of a number of resource intensive aspects of the current process. We support efforts to bring greater simplification of the process, whilst recognising that the complexity of some of the regulatory outcomes can be advantageous, if it helps to calibrate and direct network operator efforts to pursue the public interest. Features of the framework such as Uncertainty Mechanisms might be designed to work under different scenarios; consistent with providing for a baseline level of expenditure with greater focus on outputs. We note that process simplification was one of Ofgem's key objectives at the outset of the RIIO-2 process in 2017. However, limited progress has in fact been achieved in this respect, with Ofgem introducing greater complexity into the process as it progressed.

The suggestion that some aspects of the price review process may be carried out by others in order to deliver whole-system optimisation needs to be more clearly explained. For example, it is difficult to see how a single entity could carry out detailed business planning processes for each of the electricity and gas networks. Similarly, the appraisal of plans and associated decisions need to be carried out by an independent regulator under clear statutory requirements and obligations with associated processes for consultation and appeal.

Formal involvement of a multiplicity of other organisations in the regulatory process risks making the process more burdensome and time consuming, without necessarily improving the quality of final decision-making. ENA would support a review of how stakeholder engagement worked in RIIO including

where it added value and where the additional process burden outweighed the extra value created.

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

Below we comment on each of the regulatory models described.

RIIO adapted: As set out above we believe that RIIO principles and approaches should remain core to the next price review process. These can be evolved and adapted to include tools to manage uncertainty that are more targeted, quicker and more accessible and can unlock least regret strategic investment decisions needed to efficiently deliver whole-system optimisation objectives.

Ex-ante operating efficiency regime: If what is described here is akin to the previous RPI-X regime then it would not offer a better approach for addressing any weakness and future challenges. The reasons behind the move away from this type of approach is well documented.

Negotiated settlements: Notwithstanding where accountability for decisions would rest, it is difficult to see how this type of model, even for elements of the price control, could be superior to RIIO. ENA has previously advocated for enhanced stakeholder engagement in the development and approval of business plans. This approach has been partially implemented by Ofgem through the challenge, customer and user groups' structure, but we are not sure that the optimal solution has been found and the process burden in ED2, for example, was considerable over a prolonged period. A "lessons learned" review could help identify the best way forward in this respect in future, but we doubt that giving stakeholder organisations the power to negotiate a settlement would work, because they are so diverse and lack common organisation or collective mindset. A public sector regulator would still be needed to ensure that the public interest was met.

Ex-Post regime: If what is described here is akin to 'rate of return' regulation then this type of regulatory model has been shown to be inferior compared to incentive-based regulation and the lack of predictability of

future cost allowances creates uncertainty, disincentivises longer-term decision making and will likely drive-up costs of financing and delivering investment.

The time allowed for responding to the Open Letter has not allowed for full and proper consideration of whether there are elements of the broad regulatory models described above that might offer a better approach for more efficient (timing, cost and certainty) investment.

Concluding remarks

Whilst there may be aspects of other types of regulatory approaches that might usefully be utilised, we would urge caution when adopting and implementing changes from one price review to the next.

Any proposed changes should therefore be incremental and need to be well understood to ensure that there is clarity on how they will achieve intended goals, that the extent of regulation is proportionate to those goals and they are implemented in a consistent and predictable manner so as to reduce uncertainty among regulated companies and their investors. The case for any regulatory change needs to be clearly made, its purpose clearly communicated and it should be informed by proper consultation.

Now is the time for regulatory stability. The RIIO framework can with any necessary enhancements more than adequately meets the challenges for delivering efficient and timely investments consistent with whole-system optimisation, net zero and security objectives.

If you have any questions on the points raised in this response, please contact Energy Networks Association via email: regulation@energynetworks.org

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