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National Grid ESO response to Ofgem's open letter on Future Systems and Network Regulation

Dear Akshay

Thank you for the opportunity to respond to the open letter on Future Systems and Network Regulation.

As the Electricity System Operator (ESO) for Great Britain, we are in a privileged position at the heart of the energy system, balancing electricity supply and demand second by second. As the UK moves towards its 2050 net zero target, our mission is to drive the transformation to a fully decarbonised electricity system by 2035, which is reliable, affordable and fair for all.

We play a central role in driving Great Britain's path to net zero and use our unique perspective and independent position to facilitate market-based solutions to the challenges posed by the trilemma. Our transformation to a Future System Operator (FSO) is set to build on the ESO's position at the heart of the energy industry, acting as an enabler for greater industry collaboration and alignment. This will commence with greater coordination across gas and electricity strategic planning, with the ability to expand our remit to include additional energy vectors as and when needed. This will unlock value for current and future consumers through more effective strategic planning, management and coordination across the whole energy system.

We very much welcome Ofgem sharing its initial considerations of how the requirements of future systems might necessitate changes to how networks are regulated. Given the level of detail in the open letter, and the timescale available to respond, we set out some initial, high-level thoughts in this reply. We would welcome the opportunity to continue the conversation and provide additional feedback as our thinking develops further in this space.

The key points we wish to share at this stage are as follows:

- We agree that Ofgem has identified the main strategic issues, changes and challenges that the energy system is facing. It is clear that the demands of full electricity decarbonisation by 2035, and net zero across the whole economy by 2050, will require new approaches and solutions to emerge.
- As well as tackling the challenges posed by the climate crisis and achieving net zero, the needs of energy consumers in the shorter term also need to be taken into account. We are currently experiencing a major cost-of-living crisis, with energy costs at an unprecedented level. Therefore, regulatory arrangements need to ensure that the sector minimises cost and maximises value wherever possible to support a "just transition", where affordability and fairness remain imperatives to a successful net zero outcome.
- The RIIO model was designed to deliver a sustainable energy sector, provide long-term value for money, and encourage innovation and timely delivery. It has succeeded in enabling substantial investment, innovation and efficiency and generated significant consumer value since it was launched in 2010. However, the scale and pace of change that is facing the energy system means that there is certainly a case now for considering alternative regulatory models. We recognise the RIIO model has

already been adapted to some extent, and further adaptation may be a challenge. Therefore, more comprehensive options for reform should also be explored further.

- Further clarity around Ofgem's key principles and objectives for a future model of network regulation might help to determine the most appropriate form of control for the next period of system evolution; recognising that there may be a case for regulating different entities or activities via different mechanisms. For example, having regulated the industry on a **sector-specific** basis to this point (which has been appropriate given the relatively limited overlap or convergence between sectors), is the key objective to now look for synergies and trade-offs **across sectors** in order to maximise value and minimise costs on a whole system basis? If so, the form of network regulation adopted will need to reflect that prime objective.
- Whatever model is chosen, frameworks need to be sufficiently complementary and flexible to allow for decisions to be taken across vectors in a coordinated way. At the very least, this should probably involve a common set of assumptions underlying investment planning for the different vectors so that the risks of excessive optionality and/or stranded investment are minimised.
- Given the very significant investment requirements for networks as we transition to a decarbonised energy sector, any new regulatory model(s) will need to be sufficiently transparent and predictable to attract sources of low cost investment. At the same time, Ofgem should ensure that frameworks continue to incentivise the sector to innovate and deliver efficiently for consumers.
- We recognise that the FSO has an important role to play in the strategic planning of the gas and electricity networks of the future. The adoption of new and enhanced roles for the FSO may therefore impact on the shape of regulation for the energy sector, particularly in the area of investment planning. Accordingly, clear roles and responsibilities for the FSO, Ofgem, BEIS and other industry parties in this space would need to be agreed before this impact is better understood.
- It is already recognised that the ESO's bespoke regulatory model is inherently unique and flexible to allow the organisation to adapt to a changing energy landscape, as well as prioritise wider system and consumer interests in decision-making. Given the scale and pace of change anticipated across the sector, it will be equally important for this flexibility to continue through the coming years and as we become an FSO. The approach to regulation will need to reflect that, as a public corporation, the FSO will be a different type of organisation to the ESO today. Again, the framework should ensure that roles and responsibilities are explicitly defined, not just for the FSO but also for Ofgem, BEIS and other industry parties.

We welcome the opportunity to discuss any of the points raised within this response. Should you require further information or clarity please contact Adelle Wainwright, Regulatory Policy Manager in the first instance. Our response is not confidential.

Yours sincerely,

Matthew Wright

Head of Strategy and Regulation

Appendix 1 – Consultation Question Responses

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 agree that Ofgem has identified the main strategic issues, changes and challenges that the energy system is facing. It is clear that the demands of full electricity decarbonisation by 2035 and net zero across the whole economy by 2050 will require new approaches and solutions to emerge.

The energy system is undergoing a period of transformational change. Ofgem has rightly called out the importance of managing this change and, in particular, the need for whole energy system optimisation as key issues. We further agree that the issues faced by the sector are increasingly complex and may require system wide trade-offs.

We acknowledge the recognition of the key role of the FSO. The FSO is set to build on the ESO's unique position at the heart of the energy industry, acting as an enabler for greater industry collaboration and alignment across, initially, the gas and electricity networks, with the ability to expand its remit to additional energy vectors when needed. This will unlock value for current and future consumers through more effective strategic planning, management and coordination across the whole energy system.

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

The scale and pace of change that is facing the energy system means that there is a case for considering alternative regulatory models. Future frameworks need to be sufficiently complementary to allow for whole systems perspectives to be taken across vectors in a coordinated and flexible way.

The RIIO model was designed to deliver a sustainable energy sector, provide long-term value for money, and encourage innovation and timely delivery. It has succeeded in enabling substantial investment, innovation and efficiency, and generated significant consumer value, since it was launched in 2010. However, as a model which provides a level of certainty and stability for the sector, it is inherently less agile and able to adapt to changing requirements. More fundamentally, it was not designed to facilitate whole energy system decision making which is the key to enabling the delivery of net zero.

In recent years, the energy landscape has evolved rapidly, and this has led to the RIIO model being adapted to a certain extent. Greater flexibility in the RIIO model has been provided through the introduction of increasing numbers of regulatory “uncertainty mechanisms”, such as reopeners. However, as Ofgem recognises in its letter, the process, structure and form of the RIIO price control has limitations in terms of its ability to allow flexible decision making, and for decisions and trade-offs to be made across vectors.

Process, structure and form of the price control

The ESO's form of control is different to the gas and electricity networks that are also regulated under the RIIO model. It has a more flexible RIIO arrangement, enabled through its pass-through model, with a 2-year business planning process set within a 5-year price control. This flexibility has allowed the ESO to respond rapidly to change during the RIIO-2 period whilst ensuring Ofgem remains aligned with our proposals.

We believe this increased regulatory flexibility should now be considered sector wide. The current processes, structure and form of control for network companies do not provide them with the same level of agility within fixed multi-year periods to adapt to rapidly changing industry and consumer needs. Moreover, where regulatory models are misaligned, in terms of incentives and duration, it can be challenging to meet the scale and pace of change required by the energy transition.

Creation of the FSO

We recognise that the FSO has an important role to play in the strategic planning of the gas and electricity networks of the future. The adoption of new and enhanced roles for the FSO may therefore impact on the shape of regulation for the wider energy sector, particularly in the area of investment planning. Accordingly, clear roles and responsibilities for the FSO, Ofgem, BEIS and other industry parties in this space would need to be agreed before this impact is better understood.

Ofgem also explicitly calls out that the introduction of competition may provide an alternative to regulation, where appropriate. As strategic planning conducted by the FSO becomes the basis for understanding which investments unlock the maximum consumer value, decisions on delivery methodologies, including the

expanded use of competitive models, are arguably closely related. This is therefore another area where clarity on roles and responsibilities will be important to define.

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?

Given the context and case for change that has been outlined, we believe that there is indeed a case to consider alternatives to the approach taken in the RIIO-2 price control. As set out in our response to question 2, we recognise the benefits that the RIIO model has delivered to date, many of which are still important going forwards. However, we recognise the RIIO model has already been adapted to some extent, and further adaptation may be a challenge. Therefore, more comprehensive reform, of the types set out in options 2-4, should also be explored further.

At the same time, we agree that, given the scale and pace of change in industry, it may not be practical or proportionate to adopt the same framework across the full range of network activities. Recognising that different sectors face different types of uncertainties, it may be appropriate to consider using different forms of regulation across different sectors. At some level, however, they will need to be sufficiently complementary and flexible to allow synergies and trade-offs to be realised across the whole energy system.

As far as the ESO's own regulatory model is concerned, it is recognised that our bespoke form of control is already inherently unique and flexible to allow the organisation to adapt to a changing energy landscape and to prioritise wider system and consumer interests in decision-making. Given the scale and pace of change anticipated across the sector, it will be important for this flexibility to continue through the coming years and as we become the FSO. However, the approach to regulation in future will need to reflect that, as a public corporation, the FSO will be a different type of organisation to the ESO today. We believe it is crucial that the framework for the FSO is considered holistically, maximising the opportunity to consider how legislation, licences and the Strategy and Policy Statement (SPS) will work coherently to provide a clear set of expectations for the organisation. The framework should also ensure that roles and responsibilities are explicitly defined, not just for the FSO but also for Ofgem, BEIS and other industry parties.

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

Further clarity around Ofgem's key principles and objectives for a future model of network regulation might help to determine the most appropriate form of control for regulation across the sector; recognising that there may be a case for regulating different entities or activities via different mechanisms.

For example, the RIIO model was designed to deliver a sustainable energy sector, provide long-term value for money, and encourage innovation and timely delivery. Key objectives for the next regulatory period may shift to include enabling whole energy system investment or providing agility in how we deliver net zero.

Having regulated the industry on a **sector-specific** basis to this point (which has been appropriate given the relatively limited overlap or convergence between sectors), is the key objective to now look for synergies and trade-offs **across sectors** in order to maximise value and minimise costs on a whole system basis? If so, the form of network regulation adopted will need to reflect that prime objective.

Once Ofgem has established these principles, clarity will be required on responsibilities between parties. It is particularly important that there is clear demarcation between the roles and responsibilities of FSO, BEIS and Ofgem. This includes around future FSO roles such as investment planning and competition.

Having these clear principles and well defined roles and responsibilities will form a baseline on which to build the regulatory framework, which may be different for different parts of the sector.

Whatever model is chosen, frameworks need to be sufficiently complementary and flexible to allow for whole energy system decisions to be taken across vectors in a coordinated and flexible way. At the very least, this should probably involve a common set of assumptions underlying investment planning for the different vectors so that the risks of excessive optionality and/or stranded investment are minimised. Given the very significant investment requirements for networks as we transition to a decarbonised energy sector, any new regulatory model(s) will need to be sufficiently transparent and predictable to attract sources of low cost investment. At the same time, Ofgem should ensure that frameworks continue to incentivise the sector to innovate and deliver efficiently for consumers.