



Northern Powergrid's response to Ofgem's Open Letter on the next network price control review process

KEY POINTS

- The RIIO Framework has driven good outcomes since its inception. Its flexibility and focus on incentives, innovation and outputs remains right for the future.
- Customers have benefitted from the sound foundations of incentive-based regulation. Within electricity distribution these include lower costs, shorter power cuts, faster connections and better customer service.
- We broadly agree with the strategic issues facing the sector going forward and recognise that this does create challenges for future regulation, particularly given the differing nature of uncertainty across each sector and therefore what is needed in each review.
- In recent price control reviews Ofgem's response to uncertainty in its various forms has been to create a significant number of incentive and uncertainty mechanisms.
- Many of these create an unnecessary administrative burden, lack agility, harm the incentive properties and, for the most part, increase the regulatory risk faced by DNOs due to the potential for unremunerated investment.
- There is scope for incremental improvement of the existing framework, but nothing in the diagnosis points to the need to completely depart from the RIIO model. Rather it points to measured and reasoned adaptation.
- It is unclear at the moment how the high-level proposals that Ofgem sets out in the open letter are better than the RIIO model. However, of the four proposals, only the adapted RIIO model appears to have merit.
- The Future System Operator (FSO) will change the way that the sector functions. Providing the role of the FSO is appropriately scoped, it should drive real value in whole system optimisation. As it does that, the regulatory model will need to adapt to suit.
- Given the success of incentive based regulation in delivering good outcomes for customers, Ofgem must utilise it as much as possible and consider *adapting* that framework to include a sensible and proportionate approach to uncertainty.

1. Executive Summary

1. **At the outset it is important to recognise the many successes of the system of network regulation that has been in place since privatisation.** Investment is higher, costs are lower; reliability and resilience are higher, power cuts are shorter; and customer satisfaction levels are higher than anyone thought possible. Against that backdrop, it is important that Ofgem advocates for and looks to continue these regulatory successes to meet the challenges of the net zero transition, energy independence and the cost of living for consumers.
2. **The fact that something has worked well in past does not guarantee that it will continue to work well in future, but it does establish a high bar for any decision that seeks to modify the arrangements.** We would also note that careful thought went into the RPI-X@20 review from across the industry and it was considering similar challenges to those that Ofgem outlines in its open letter. This review must be equally thorough.
3. We broadly agree with Ofgem's characterisation of the strategic issues facing the sector and we recognise that they do create challenges for future regulation, not least because **the outlook is likely to be very different in each sector.** For instance, the need to rise to the challenge of load growth and the new generation of electricity networks differs greatly to the uncertainty surrounding the future of gas and the extent to which the gas networks needs repurposing to transport hydrogen.
4. Although the transition to net zero brings much greater uncertainty than the industry has faced previously, **it is certain that all of the decarbonisation pathways require increased investment in the electricity distribution networks.** So it is more important than it has even been that – for ED – Ofgem preserves the incentives on network companies to minimise total costs and to reveal information for future price controls.
5. In recent price control reviews Ofgem's response to uncertainty in its various forms has increasingly been to introduce a bespoke reopeners or uncertainty mechanisms. That trend is showing no sign of slowing down and there is now a significant number of adjustment mechanisms in the suite of RIIO price controls. We believe that many of these create an unnecessary administrative burden, lack agility and harm the incentive properties in the price control. Furthermore, some increase the regulatory risk faced by DNOs due to the potential for unremunerated investment.

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6. As a result, Ofgem's current framework now lacks coherence, risks undermining investor confidence and, in the case of the upcoming RIIO-ED2 period, might fail to create meaningful drivers for innovation and efficiency and the associated improvements that would result for consumers.
 7. We think it is very important that Ofgem recognise that the effectiveness of the RIIO framework has also varied across sectors. This is largely driven by the different structures in each sector and the range of comparators available to Ofgem, and a misguided desire within Ofgem to drive uniformity in the frameworks across the sectors, rather than failings in the principles of the RIIO approach.
 8. This does suggest that **there is scope for incremental improvement of the existing framework, but nothing indicates that Ofgem should depart from the fundamentals of the RIIO model.** In fact, the evidence strongly supports an approach that takes great care not to throw the baby out with the bathwater. In other words, there is a need for measured and reasoned adaptation.
 9. It is unclear at the moment how the high-level proposals that Ofgem sets out in the open letter are better than the RIIO model. **However, of the four proposals, only the adapted RIIO model appears to have the most merit.**
 10. Strong incentives, including for investment, cost efficiency and consumer outcomes, are essential to deliver the significant benefits to consumers from the lowest-cost pathway to meeting net zero targets. To that end, given the success of incentive based regulation in delivering good outcomes for customers, Ofgem must utilise it as much as possible and consider *adapting* that framework to include a sensible and proportionate approach to uncertainty. This balance is achievable but it requires serious deliberation and a coherent approach that is calibrated for each sector.
 11. In addition to the challenges that net zero presents, policy decisions also have significant ramifications. For example the creation of the Future System Operator (FSO) will change the way that the sector functions. We can understand the rationale that led to the creation of this body and, providing the role of the FSO is appropriately scoped, it should drive real value in whole system optimisation. As it does that, the regulatory model will need to adapt to suit.
 12. Another key policy decision being contemplated by Ofgem is the future of DSO. DSO separation would negate the benefits of the distribution equalised incentives regulatory framework and lead to the conflicts of interest and lack of optimisation that Ofgem is seeking to avoid. Ofgem's future decision on institutional arrangements in electricity distribution has the potential to further exacerbate the issues being considered in the open letter.
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13. Other policy decisions, such as the Access and Forward-Looking Charges Significant Code Review (the 'Access SCR') in electricity distribution have broad ramifications. The changes to electricity distribution access rights and the move to socialise a far greater proportion of connections reinforcement costs have the potential to significantly impact the volume, type and location of connections, and in turn, the amount of network reinforcement triggered and costs to the DNO and therefore consumers. The impact of these policy decisions may be substantial but also subject to a significant degree of uncertainty. **The impact of broader policy decisions also needs to be considered.**

We stand ready to work with Ofgem and as we approach the review we're looking to build on and retain the successes of the existing framework, and ensure that any changes to a framework that has clearly worked are evidenced.

2. Detailed Response to Ofgem's questions

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

14. We broadly agree with the Ofgem's characterisation of the strategic issues facing the sector.
 15. We recognise the challenges that Ofgem has set out in its open letter and understand Ofgem's desire to assess the sufficiency of the current framework in responding to these challenges. **But at the outset it is important to recognise the many successes of the system of network regulation that has been in place since privatisation.** Investment is higher, costs are lower; reliability and resilience are higher, power cuts are shorter; and customer satisfaction levels are higher than anyone thought possible. Against that backdrop, it is important that Ofgem advocates for and looks to continue these regulatory successes to meet the challenges of the net zero transition, energy independence and the cost of living for consumers.
 16. Ofgem is correct that the challenges of net zero differ sector-to-sector. During the 2020s and beyond there will be greater reliance on electricity distribution networks to heat homes and power cars. At the same time more generation is being connected to distribution networks.
 17. Ofgem reflected this when developing the RIIO-ED2 framework, saying that:
 18. *"In many ways, the electricity distribution sector is likely (though it is not certain) to be the most dynamic of all the regulated energy sectors. We expect the electricity distribution networks to see the greatest impact arising from the forces of decarbonisation, decentralisation, and digitalisation."* [Open Letter Consultation on the RIIO-ED2 Price Control, August 2019, page 5]
 19. Similarly, electricity transmission needs to be able to respond to the increase in new sources of power generation from sources like offshore wind and new nuclear and optimise this blend of generation and demand nationally.
 20. Whereas, as Ofgem recognises, the challenges facing gas distribution are almost entirely different given that *"[a]s new zero carbon power comes online, the volume of natural gas used in power generation is likely to continue to fall. Decarbonisation of industry and heating may also see this demand further decreasing."* [Open letter on the next network price control process, 2022, page 2]
 21. The different directions of travel of the sectors does present Ofgem with a clear challenge when thinking about future price control frameworks. We have witnessed Ofgem wrestling with this problem for some time throughout subsequent RIIO price controls, reshaping the framework by
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degrees. Unfortunately this fragmented approach has arrived at a framework that now lacks coherence, risks undermining investor confidence and that hasn't been equally effective in all sectors. In the case of the upcoming RIIO-ED2 period, Ofgem's framework might fail to create meaningful drivers for innovation and efficiency and the associated improvements that would result for consumers.

22. There are more uncertainties across the energy industry than just those relating to net zero. Specific to electricity distribution, Ofgem's policy decisions relating to the Access SCR and DSO have created other significant uncertainties that must be addressed.

Access SCR

23. The Access SCR has broad ramifications from how customers pay for a connection to, and access the distribution network, to how DNOs manage network capacity. These changes have the potential to significantly impact the volume, type and location of connections, and in turn, the amount of network reinforcement triggered and costs to the DNO and therefore consumers.
24. This will impact network company reinforcement costs in two ways: first, it will have a mechanistic impact whereby a proportion of reinforcement costs that was previously expected to be customer-funded will now be socialised. Second, it will impact customer behaviour, due to the reduction in the overall cost of connecting to the network and the dampening of a locational signal as to where a customer can locate without a need for reinforcement. Specifically, we would expect this behavioural impact to lead to an increased volume of connections, an increased average size of connections and some shifting of connections into more congested areas with greater reinforcement requirements. As a result, DNOs need a flexible mechanism to manage this uncertainty, whilst recognising the potential impact it will have on the transmission network.
25. Our projections suggest that the impact of the Access SCR proposals may be very substantial and subject to a significant degree of uncertainty. Our business plan analysis indicates that the impact of Access SCR could increase our RIIO-ED2 baseline reinforcement costs of around £64m up to around £77m against the lowest impact scenario and over £510m in the highest impact scenario.

New market participants

26. Ofgem rightly identifies that the decision to create the FSO in Transmission has changed the structure of the electricity industry. The FSO, with its remit to affect change in both gas and electricity network operation trigger new demands that the regulatory process will need to allow for.

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27. We can understand the rationale that led to the creation of the FSO as a means to address the failings in the regulatory incentive system that meant cost incentives were different across Electricity System Operator (ESO) and Electricity Transmission Owner (ETO), creating a potential or actual conflict of interest. Separation of the ESO from the ETO perpetuated these unequal cost incentives, and in so doing perpetuated the potential conflict of interest. The latest regulatory framework, with pass through costs for the ESO but with continued cost incentives for the ETO, has created even further scope for a conflict.
28. Separating the FSO from National Grid ETO will help to address this issue, and it allows for public ownership which we believe is more appropriate given the FSO's roles across the entire energy system.
29. We also recognise the impact that the DSO could have in the sector, as the guardian of whole system solutions and being the key mover on ensuring the meaningful uptake of flexibility. Ofgem's continued consideration of institutional arrangements and DSO governance are themselves a significant uncertainty, and one that has a significant downside associated with it.
30. DSO separation would negate the benefits of the distribution equalised incentives regulatory framework:
- a. Perceived conflicts of interest in investment decisions at distribution are mitigated through equalised incentives, unlike the problematic regulatory framework that was present in transmission.
 - b. DSO functions taken on by others would negate the benefit of totex benchmarking across DNOs which enables Ofgem to set efficient price controls, driving up costs for consumers.
 - c. The potential for synergies across investment categories, notably between investment in asset maintenance and reinforcement, would be lost, raising costs and negatively impacting service quality and network resilience.
31. However, we believe that as a combined entity (DNO and DSO), we are uniquely placed to leverage synergies between the system operation and network operation components of our business given particularly that, at the distribution level, the regulatory framework can (and does) mitigate any potential conflicts of interest between these two business components.
32. The theoretical concerns raised by proponents of DSO business separation are all already extensively addressed by the design of the current regulatory framework and the package of measures envisaged for the ED2 period.
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Security of Supply

33. We are surprised that Ofgem's open letter fails to mention security of supply in its consideration of strategic issues. One of the key customer outcomes throughout the course of network regulation has been improved availability and reliability of the networks and the incentives and outputs in the RIIO regulatory framework have rightly targeted performance in this area. This will undoubtedly continue and take on new shape in a society that is becoming increasingly dependent on electricity for its use in transport and heating.
34. Through time, the framework has increasingly been adapted to meet new risks such as cybersecurity and going forward it will need to address the increased needs of an increasingly resilient energy system that adapts to climate change and global energy availability and price risks (as demonstrated most recently in the disruption to European gas supplies).

Wider perspectives - whole system thinking and stakeholder engagement

35. A key issue for the next set of price controls is the extent to which whole system thinking and stakeholder engagement are factored into the processes used to determine price control review outcomes. These matters come to a head with ambitious plans from local authorities that are seeking to drive forward regional decarbonisation. Local area energy plans will be increasingly underpinning investment plans and Ofgem needs to consider how the costs and outputs for this cross-vector co-ordinated work will be recognised alongside traditional comparative cost benchmarking techniques that have been historically the prime determinant of price control review decisions.

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

36. Across the sectors, it is reasonable to suggest that the RIIO model has had mixed results. Some of that has been driven by the different structures in each sector, the variance in independent comparators and the length of time that output incentive performance has had to drive company development.
37. However, it is also right to recognise that the model has driven higher investment, lower costs, vastly improved customer service performance, higher reliability and availability, faster connections, ambitious innovation and investment that lays the groundwork for a net zero future.
38. **Ofgem suggests that the whole system transformation and optimisation and uncertainty cause the RIIO model to strain. We disagree.** While incentivising whole system solutions can be difficult,

we believe that the RIIO framework is able to properly incentivise it. Some of the core mainstream mechanisms in the RIIO model can be utilised to drive whole system outcomes. The key incentives are the incentive on business planning and totex efficiency. The former should be used to incentivise companies to submit plans and forecasts that provide whole system optimised and stakeholder endorsed outcomes. For the latter, the totex cost sharing efficiency incentive can be used to keep a constant focus on delivering the committed outcomes for less.

39. Therefore, Ofgem must not ‘throw the baby out with the bathwater’ as it is not the case that the framework is wholly inappropriate, but that it may require some conscious and deliberate development of flexibility within the framework to better focus on relative outputs and respond to uncertainties. Ofgem should build on the strong foundations laid over recent decades when considering future price control frameworks. That isn’t to say the framework must remain rigid, instead it should be adapted while maintaining the many benefits arising from a strong incentive-based regulatory construct.
 40. In recent price control reviews Ofgem has ‘drifted’ into a space of trying to address uncertainty in the RIIO framework through an adhoc mix of decreasing ex ante allowances and increasing use of uncertainty mechanisms. Ofgem current position is not optimal as it lacks coherence and undermines the stated intent of the RIIO framework at its inception. This has resulted in the proliferation of uncertainty mechanisms and RIIO-2 price controls with weak and asymmetric incentive controls that will fail to create the drivers for innovation and efficiencies and the associated improvements that would otherwise result for consumers.
 41. Strong incentives, including for investment, cost efficiency and consumer outcomes, are essential to deliver the significant benefits to consumers from the lowest-cost pathway to meeting net zero targets. To that end, Ofgem must retain incentive regulation for as much as possible and consider *adapting* that framework to include a sensible and proportionate approach to uncertainty.
 42. Ofgem should consider the extent to which certain costs are predictable or unpredictable and consider different treatments for each.
 43. Ofgem recognises the strength of upfront allowances and strong incentives for the predictable costs, such as operations, maintenance and new investment. The existing framework, properly calibrated, allows for regulatory certainty, an equitable Cost of Capital, and the freedom for the DNO to innovate and drive efficiencies and synergies across its business.
 44. We think that there is a coherent way forward that allows Ofgem to retain many of the longstanding qualities of incentive regulation while handling the more uncertain elements
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differently. This would also allow Ofgem the ability to account for the different challenges being faced by the different sectors.

45. Turning to some of the specific points you ask us to comment on in your letter that we have not already covered:

- a. ***The process associated with the RIIO framework:*** The process can be improved but Ofgem must first deal with the strategic issues it has set out as form follows function. The current framework become overly administrative and seeks to micro-manage the network companies. Ofgem needs to outline its approach to regulation of both predictable and unpredictable costs, and then shape proportionate processes that allow for effective regulation.
- b. Ofgem has moved to model of working groups and stakeholder engagement to shape the framework and has failed to engage with the industry's senior executives. Ofgem's own senior leadership has been too far removed from the process and failed to engage meaningfully with the CEOs and Executive of the organisations. This lack of senior oversight has led to poor decision making, and a lack of scrutiny and challenge from the key decision makers in the industry.
- c. ***Structure and form of the price control:*** The challenges facing the electricity and gas sectors differ. While it is necessary to support and incentivise whole system optimisation, Ofgem must avoid seeking to rigidly apply the same framework across all sectors. We have long argued against the roll-forward of transmission and gas distribution mechanisms into electricity distribution as it simple fails to appreciate the difference between the sectors. That difference is now becoming more pronounced. However, incentivising whole system solutions doesn't mean that the controls must be identical, it is entirely feasible to develop complementary frameworks.
- d. ***Periodic reviews:*** The periodic review process continues to make sense. Ofgem could review whether it is sensible to separate out the predictable and unpredictable elements of the networks' operations and consider whether a different approach is needed for both. It is definitely the case that most of a network's operations are suitable for periodic review that sets ex ante allowances, strong incentives and reasonable cost of capital.

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?

46. Many of the comments above speak to this question. The fundamental principles of RIIO are sound and are necessary for the pursuit of net zero, and Ofgem should not abandon these principles. Ofgem should continue to utilise incentive-based regulation for as much of the price control as possible.
47. Any change that is considered should be a development that builds on these principles rather than a move away from them.

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

48. Of the variants set out in the letter, we support consideration of the RIIO adapted approach.
49. The ex ante operating efficiency regime would not appear to give the flexibility necessary for the uncertainties that have been set out and would fail to take advantage of the benefits of comparative analysis.
50. Negotiated settlements would lead to less accountability and clear decision making and further increase the complexity of the price control review and the subsequent administration of the price control. Ofgem has already heightened the role of the stakeholder voice in the regulatory process through the creation of the Customer Engagement Group (CEG) and the Challenge Group (CG). Companies have devoted a significant amount of time and effort to engage with these bodies, and these bodies have informed the plans developed by the network companies, but Ofgem has taken decisions unilaterally. Negotiated settlements would essentially amount to a very material increase in the role of the CEG and CG, and a notable change in Ofgem's decision making.
51. An ex post regime would disincentive investment in the industry by removing certainty around allowances at precisely the time that more investment is needed.