



Rebecca Barnett
Interim Director of Networks, Ofgem

3 May 2023

Dear Rebecca,

S&C response to Ofgem Consultation on Frameworks for Future Systems and Network Regulation

We welcome the opportunity to respond to Ofgem's consultation document entitled 'Frameworks for future systems and network regulation: enabling an energy system for the future.'

Overall, our position remains as set out in our response to the Open Letter in October. The challenges facing our networks continue to evolve and, in that context, it is important to review the regulatory framework to ensure that it meets the challenges and takes advantage of the opportunities that lay ahead. On this basis, we welcome the fact that Ofgem has identified the RIIO-2 approach as the 'counterfactual' and that any move away from that approach would need to be demonstrated to deliver net benefits.

Ofgem's approach recognises the benefits already inherent within RIIO and that it represents a solid foundation to build upon. One of the key benefits of the RIIO framework is its inherent flexibility as a regulatory approach which offers significant opportunities for refinement to address the challenges Ofgem has rightly identified.

We note that Ofgem's states that "traditionally ex-ante incentive regulation arose from the fact that licensees possessed detail expert system knowledge of asset and demand conditions, while the regulator did not.... Whole system planning requires a substantial reduction in the asymmetry." Ofgem highlights that this brings new options to the table. We are not convinced that the changes to system planning and regulation as part of the energy system transition will significantly reduce asymmetries. If anything, they may become more complex as there are a wider range of stakeholders involved including the Future System Operator, Regional System Planners, developers, and aggregators. Further, network companies will still have a greater knowledge of asset condition and risk and have responsibilities for planning large proportions of their investment and operational activities.

In Appendix 1 we set out our responses to the specific questions raised in Ofgem's consultation. We have not sought to provide answers to all the questions raised, rather we have focused attention of the most relevant areas from our perspective.

Please do not hesitate to contact me if you have any queries on this letter or wish to discuss any particular elements of it.

Yours sincerely,

Chris Watts
Director – Regulatory Affairs



Annex 1 – S&C Answers to Ofgem questions

Main Body

Question 1: What should the role of the ‘consumer voice’ be and through what institutions and processes should it be channelled?

S&C Response

We consider that it is vital that the ‘consumer voice’ is well integrated both as part of price control business plan development by the network companies and as part of Ofgem’s review of those plans and its development of policy and its price control determinations. This should be a layered approach including engagement with a wide range of consumers and stakeholders and different representative through a range of methods such as focus groups, one-to-one meetings, surveys, panels, and newer approaches such as Citizen’s Assemblies.

We consider that the Customer Engagement Group (CEGs), User Groups, and the Ofgem Challenge Group played a key role in ensuring that consumer and broader stakeholder views were effectively built into the RIIO-2 plans and resulted in a higher quality of plans than previously seen. However, Ofgem should give greater thought to how the inputs from these groups are factored into its business plan assessment.

The role of these groups can continue to evolve both in terms of their ongoing role during the price control periods as well as their input to future price controls. There may be elements of the price control which are suitable for a negotiated settlement. It is worth considering learning from approaches adopted elsewhere such as the role of intervenors in North America and the NewReg trial for AusNet in Australia.

Question 4: What is your view on the options identified for simplification of incentive regulation? What would be the benefits and costs by comparison to the approaches in RIIO-ED2?

S&C Response

While appropriate levels of simplicity are a crucial element of regulation so that all parties have a good understanding of the mechanisms and associated incentives, and unnecessary regulatory burden is avoided, it is also important that the regulatory arrangements aren’t over-simplified to the point they lack robustness. There are also risks that perceived simplifications may re-introduce unintended complexities that were previously addressed.

With this in mind, we have some concerns about a potential shift back towards a ‘simpler’ RPI-X approach even if this is for certain activities. For example, a shift back towards the separate treatment of operating (opex) and capital expenditure (capex) would create boundary issues between opex and capex which would add complexity have to be managed through additional regulatory reporting. It would also reduce the ability for network companies to achieve efficiencies through optimisation across different categories of expenditure. The application of different controls to different elements of the business creates similar risks.

Greater use of ex-post productivity-based mechanisms within an overall ex-ante mechanism may have the appearance of simplifying the approach to cost assessment. However, it would introduce risk for the network companies and weaken efficiency incentives if network companies are unsure of the treatment of costs when they make their investments and operational decisions. It’s worth noting that the decision to move to ex-ante cost assessment and incentives, where possible, was made based on the difficulty of conducting ex-post cost assessment for all involved.



With regards to balancing risk and reward for both network and consumers over a transition that occurs over multiple price control periods, the combination of using appropriate uncertainty mechanisms such as agile reopeners and volume drivers in combination with strong efficiency incentives provides an appropriate means of ensuring that consumers' long-term interests are met.

We consider that the development of the Network Asset Risk Metrics (NARM) and the Network Output Measures (NOMs) before that have been crucial elements of ensuring that there is a strong evidence-based foundation both for network companies to forecast asset replacement and refurbishment spend and for Ofgem to review these forecasts. This is important in ensuring expenditure is not duplicated across periods and ensuring the efficiency of spend. While there are clearly costs with carrying out such analysis, these activities are an important part of asset management.

Question 5: What are the network activities where there would be benefits for a move to an ex-post monitoring regime, and what would be the associated costs?

S&C Response

Load-related and DSO activities are the areas most likely to be suitable for a move to an ex-post monitoring regime. By their nature, these activities will be quite different moving forwards to the equivalent historical costs as they underpin the energy transition with greater volumes of distributed generation and electrification of heat and transport and more active management of the distribution networks. There are already uncertainty mechanisms associated with these areas and element of ex-post monitoring.

Non-load related expenditure and operational activities can be planned over a longer period, are repeatable activities, and are more suitable for longer-term ex-ante assessment and incentives.

Question 7: What is the potential for Electricity Distribution planning and commissioning to move to an alternative model by the end of RIIO-ED2 and what might be the benefits and costs of doing so?

S&C Response

It is important to consider here both what is covered by Electricity Distribution planning and commissioning and what might be covered by an alternative model by the end of RIIO-ED2. Only a proportion of electricity distribution investment will be larger one-off distribution capacity investments, and a significant proportion will relate to smaller repeated asset replacement investments. By the end of RIIO-ED2 it might be appropriate for some elements of large distribution reinforcement investment to be planned by Regional System Planners and alternative models for procurement such as tendering by the RSPs to be carried out, but this would be unlikely to apply for the majority of investment.

APPENDIX 3

Question 1: Can separable categories of expenditure for repeatable activities be defined that will allow for:

- An alternative, simpler ex-ante regulatory framework (including cost assessment approach) to be applied for a separable group of costs and outputs?
- A simple ex-post productivity-based incentive to be defined (either against an external benchmark and/or benchmarked against other network companies) as an alternative to 'ex ante' productivity targets.



S&C Response

As noted in response to question 4 in the main document, there are risks associated with moving to a simpler ex-ante framework (including the cost assessment approach) for repeatable activities. Such a framework may add additional complexity in terms of ex-post reviews as well as weakening incentives for optimising opex and capex across activities.

As noted in response to question 5 above, load-related and DSO activities are most likely to be suitable to a move to an ex-post monitoring regime given the degree of flexibility required for such investment.

Question 2: Under what circumstances would these options be more or less effective than the current RIIO framework?

S&C Response

These 'simpler' approaches would only be more effective to the extent that they avoid additional complexities associated with ex-post reviews and additional reporting burdens. However, we consider this is unlikely to be the case.

The existing RIIO framework has strong ex-ante incentive properties with totex incentives, output and outcome metrics, which encourage optimisation across activities. RIIO also has flexibility in the form of uncertainty mechanisms and incorporates elements of ex-post review for close out. The framework is inherently flexible and can incorporate more or less of many of the elements being considered without a fundamental change in the framework.

Question 3:

Are there activities where cost efficiency is hard to measure, and a pure ex post review might become more appropriate?

S&C Response

Where cost efficiency is harder to measure, a pure ex-post review is less rather than more likely to be appropriate. An ex-post review inherently involves an element of cost assessment where there is an information asymmetry between the network company and Ofgem. In these circumstances ex-ante incentives which lead to revealed efficiencies are more likely to be appropriate than an ex-post monitoring and review.

Question 4: For these options, what level of monitoring would be required to ensure that customers are 'getting what they are paying for' from the level of investment in base activities?

For options such as an ex-post review to be workable there would need to be clarity upfront on the cost reporting associated with the activities, how the outputs or outcomes will be measured, and the methodology for the ex-post monitoring. Without such elements efficiency incentives are likely to be weakened.



APPENDIX 5

Question 1: If we were running RIIO-2 again, what lessons can we learn from the process through the lens of simplification, in the following areas:

- The business planning process (e.g., governance, timelines)?
- The price control review process (cost assessment, outputs, and incentives)?
- The approach to ongoing network performance monitoring (particularly for GD/GT and ET, although we welcome early observations from the ED sector)?

S&C Response

Overall, we agree that simplification is an important consideration for a regulatory framework and undoubtedly lessons can be learned from the RIIO-2 process. Having said this, we would also reinforce the view that simplification should not be at the expense of the robustness of the framework. By its very nature there is complexity in network regulation and thus the focus should be on removing unnecessary complexity.

For the three components Ofgem has identified we would note the following:

- **Business Planning Process** – We consider Ofgem has broadly achieved the right balance in this area. The requirement to develop and submit detailed business plans supported by robust stakeholder engagement has been an extremely positive component of RIIO. The quality of the plans in RIIO-2 has reinforced this. While it may be possible to reduce the number of stages of the review and, by doing so, allow more time for the network companies to develop those plans, the basis of the approach remains appropriate and, in our view, does not create undue complexity. One area for potential improvement is the finalisation of the Business Plan Guidance documentation at an earlier stage in the process. This is important to avoid compressing the time for development of the plans and avoiding significant rework.
- **Price Control Review Process** – The approach to cost assessment is critical to the success of a regulatory framework. Robust and detailed cost assessment is necessary to give confidence to all stakeholders, including the network companies, that the allowed expenditure is justified and necessary to deliver the levels of investment required by customers. Ideally there should be clarity on the main assessment methods before the cost assessment process begins. In order to achieve this, it is important to keep the toolkit for cost assessment up-to-date by running it and refining it with the annual iteration data.

In relation to outputs and incentives there is more scope to weigh up opportunities for simplification. In many ways it could be argued that the output framework became more complex in RIIO-2. The starting point of grouping the five categories used in RIIO-ED1 into three consumer-facing output categories was positioned as a move towards simplification but the significant overlaps between the areas as well as the introduction of Price Control Deliverables (PCDs) and Output Delivery Incentives (ODIs), added additional layers of complexity to the process. Going forward, this could be an area to focus on to seek to reduce the levels of complexity in the framework while retaining the higher priority metrics.

- **Ongoing Monitoring** – Monitoring is another key component of a price control framework to give confidence to all stakeholders that the process is delivering what it was intended to. The



key is ensuring that the process does not place an undue burden of both the companies on the level of detail required to be reported and indeed on the Ofgem teams in undertaking an assessment of any information provided. In other words, there is no point collecting information that is not assessed and for which there is no transparent output. On this basis, there is likely to be scope to consider how regulatory reporting could be rationalised.

Question 2: What benefits did the RIIO-2 business plans deliver and how important are the business plans in identifying and shaping key RIIO building blocks (e.g., ODIs, PCDs, Strategic Investment, BAU costs)?

S&C Response

As noted above, we consider that the requirement to develop and submit detailed business plans supported by robust stakeholder engagement has been an extremely positive component of RIIO. Generally, we consider that the quality of the plans was very high in RIIO-2. In part, this can be attributed to clear business plan guidance that provides network companies clarity on their requirements. It also reflects learning on the part of the network companies in refining how they capture and present key information. One particularly positive development was the requirement to develop and present a broad range of Engineering Justification Papers (EJPs). These added to robustness of the overall process of investment planning.

Two other observations we would make:

- (1) Range of building blocks – As highlighted in response to the previous question, there were a greater number of building blocks reflected in the RIIO-2 framework which, in itself, creates complexity. Going forward, this would be the area to focus on if there were an aim of reducing complexity. This in turn may help the network companies in developing their business plans.
- (2) Bespoke Outputs/ Uncertainty Mechanisms – We welcomed this approach as a recognition that there are genuine differences between the needs of stakeholders in different parts of the country. However, the success rate of companies' proposals was fairly low implying that the burden of proof for bespoke mechanisms was extremely high. Going forward, Ofgem needs to consider the role bespoke mechanisms can play so companies can be more targeted in developing their plans.

Question 3: Broadly, how do the RIIO business plans differ to companies' own internal business plans used over the regulatory cycle?

This is clearly more of a question for a network company to answer. While we would expect differences between the level of detail in internal plans when compared to public facing business plans that are required to meeting certain publication requirements, we would also expect that each company's business plan should be a clear articulation of all key issues driving any internal plans. In other words, we would expect the content to be consistent.

Question 4: What changes may be needed to the role of consumer engagement during the price control review?

Consumer engagement has become a core part of the RIIO framework. This is a positive in that the changing roles of networks has meant that more parties have a direct interest in how network



companies are investing to meet their evolving needs and therefore it is important that there are mechanisms to enable views to be heard. Both the network companies and Ofgem are to be commended for their commitment to engagement.

It is therefore also positive that attention has turned to considering engagement during the price control period. This is a recognition that engagement is not something that is only relevant every 5 years but must be embedded in ongoing processes. This means it evolves to consider the question of 'how' to deliver as opposed to just a focus on the 'what.'

The main challenge going forward is to avoid engagement fatigue. There are so many processes underway led by several different parties, that there is undoubtedly there is a risk of losing some focus. That is why both the network companies and Ofgem need to be quite targeted in identified the areas for engagement, the timing of the required engagement and the critically who should be engaged in specific areas.

Question 5: Could potential changes to the regulatory frameworks represent an opportunity for different forms of consumer engagement in particular areas of the price control?

Undoubtedly, changes to regulatory frameworks would have implications for forms of stakeholder engagement. All engagement should be meaningful and thus have a purpose to serve in informing both how companies deliver their plans but also Ofgem's decision making.

As mentioned above, the key is to make engagement targeted so that the right parties are engaged in discussions at the right times in order that their impact can be meaningful. It also means considering the form of engagement that is best suited to each area. This is likely to mean a combination of approaches that are informative, consultative, or participatory.

Question 6: What can we learn about improvements to asset health monitoring approaches and its implications for future regulatory design?

As both the threats to networks and our reliance on those networks have increased, then the importance of asset resilience has also increased. Rightly, there was a far greater level of focus on resilience in RIIO-2 than ever before and we would expect this trend to continue with subsequent implications for future regulatory design.

Ofgem has made considerable progress in the development of the Network Asset Risk Metric (NARM) framework as a tool to quantify the benefits of companies' asset management activities. In particular, significant strides have been made in expanding the focus on asset management and ensuring consistency within and, where appropriate, across different sectors. As with the broader RIIO framework, the NARM is a tool that can evolve with the challenges to asset health and provides a strong evidence-based approach for both assessing and reviewing asset replacement and refurbishment plans. We note that Ofgem has been a leader in this area, and we are seeing other jurisdictions moving in this direction. For example, Toronto Hydro in Ontario has adopted a revised version of the Common Network Asset Indices Methodology. In discussions of resilience and investment planning in the U.S. an important trend has been a move toward monetised asset risk as part of investment planning and cost-benefit analysis. Therefore, we would encourage Ofgem to look at ways of building on this framework.

At the same time, we recognise that technological solutions will continue to evolve to support asset health. We have seen a greater focus on automation, sensors, reclosers, and smart switchgear solutions to enable the detection of outages and quickly recover or reconfigure the grid to minimise disruption. Climate change has also impacted the economics of investment with a trend toward undergrounding. It is important that



regulation recognise these trends and support investment in innovation that will improve the robustness of the network and the customer experience.

Overall position

We understand Ofgem's desire to ensure it has the right regulatory framework in place to meet the challenges and opportunities that lay ahead. Undoubtedly, this is likely to necessitate change to the current approach and there are definitely lessons to be learned from RIIO-2.

However, rather than considering options which would represent a fundamental shift away from RIIO, we think the key question Ofgem should focus on is - where are there weaknesses in the existing arrangements, how to refine the RIIO framework to best address those weaknesses? Only by doing so can Ofgem ensure the regulatory framework best meets the future needs of the energy system and, more importantly, the needs of the future customer. To do otherwise risks creating more uncertainty and greater complexity which would result in Ofgem losing many of the significant strengths of the RIIO framework.