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Our ref: FSNR Consultation Response

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By email only to FutureNetworkRegulation@ofgem.gov.uk

Dear Akshay

BUUK welcome the opportunity to respond to Ofgem's consultation of Future System and Network Regulation (FSNR). BUUK is the parent company for independent network licensees across both gas and electricity sectors and the outcomes of this consultation and future work in this area will directly impact those licensed companies. Further, BUUK operates an independent water network and retail business who operate under Ofwat's regulatory framework, and an open access fibre optic network regulated by Ofcom. Working across different frameworks and regulators gives us a unique position to provide feedback and insight into Ofgem's potential reforms.

We have provided answers to Ofgem's questions in the appendix of this letter but there are several key themes that we have picked out to Ofgem's attention in this letter.

- Established, market driven competition, has provided significant benefits to the market and should continue to be encouraged to develop innovative solutions to meet the transition to net-zero.
- Regulation should not, at this stage, be overly prescriptive or set in such a way which forecloses potential enablers to net-zero.

Independent network operators have played a significant role in developing agile, innovative solutions for connections and have been able to challenge incumbent operators to ensure the most beneficial outcomes for customers. An economic regulation framework should continue to encourage the ability of market participants who have already demonstrated their ability to react to customers, focus on innovative solutions and bring those solutions rapidly to market. The rate of change in the development of the energy networks will benefit from the range of benefits that this competition can bring. Full competition, enabled by consumer choice, will drive innovation and reduce costs to all consumers and it is paramount that, in determining an approach for future network regulation, Ofgem does not put in place structures or policy which do anything to inhibit competition from developing.

We also believe that it is important that regulatory frameworks are flexible and are not prescriptive on requirements or solutions at this transitional stage. There are likely to be a

variety of solutions to meet the range of challenges that GB faces and the framework must be broad and agile enough not to preclude a change of direction whilst ensuring that investor confidence is maintained to reduce costs to customers.

We understand that this consultation, and the work which will underpin it, is intended to set the high-level framework to ensure that cost can be incurred efficiently and the impact to end users' bills arising from the transition to net-zero is minimised. It is imperative that the high-level framework achieves this objective, but it is also important for Ofgem to consider how, and from whom, these costs are recovered. The mechanisms for cost recovery are likely to be equally as important to minimising the impact to customer bills as these might drive behaviour which increase efficiency in the network and reduce overall system costs. There is work ongoing in the electricity industry (through Ofgem's TNUoS Task Force and DUoS SCR) to determine the most effective approach to cost recovery. It is important that each of these areas of work is aligned and joined up with the outputs from this consultation.

Should you wish to discuss this response in more detail then please contact me and we would be happy to discuss in depth.

Yours sincerely

Keith Hutton
Group Regulation Director

Appendix 1 – Responses to questions

Q1. What should the role of the ‘consumer voice’ be and through what institutions and processes should it be channelled.

We think that is important to remove the homogeneity presented by the use of the singular ‘voice’ and would prefer that this is be considered ‘voices’ in the plural. The needs of future energy users are likely to be wide and varied (as Ofgem notes in its consultation) and it is important to shift to this paradigm in the language we use around consumers.

The role of consumer voices should be, in our view, to advocate for the correct balance of desirable outcomes throughout the regulatory framework. It is likely that consumers will have, at times, opposing views which directly contradict, and it is important to take cognisance of this difference in stakeholder needs. Arguably, this advocacy should be omnipresent throughout the period(s) of the negotiated settlement, from establishing frameworks to determining the outcomes of re-openers. This could be achieved through the use of shadow consumer boards with representatives drawn from existing institutions and charities (Citizen’s advice, National Energy Action etc.) and well known consumer advocates as well as from a general, representative cross-section of society.

We believe that Ofgem’s access to consumer voices should be unfettered and unimpeded and it to be for Ofgem to weigh the needs of those consumer voices against each other and other priorities or statutory requirements to determine the outcomes.

Q.2. How detailed could an independent, cross vector view become to determine future plans for periods beyond RIIO-2 and support effective use of the ‘Plan and Deliver’ model?

We note that Ofgem has recognised that one of the main issues which regulatory price controls seek to overcome is the asymmetry of information. We believe that this is likely to be an issue which persists with the plan and deliver model and may inhibit the development and detail of independent, cross-vector plans. We recognise the benefit that this had had at electricity transmission level but this benefit is likely to be significantly diluted at the distribution level, especially at the lower voltages of the distribution level where obtaining the necessary level of detail, across each region in GB, is likely to be challenging. There is a natural tension between vectors within the energy system and it is unclear how, notwithstanding the potential for an increase in data, the FSO will be able to overcome the asymmetry of information which is faced by regulators.

Q.3. Under what circumstances would competition, or other procurement models such as open book contracting have benefits over ex ante incentives as a cost control mechanism.

As an independent network operator across utilities we have seen the benefit that competition can bring for customers seeking connections to the energy networks. We operate in an open market where we compete for the provision of assets in gas and electricity networks and connections to new premises and sites. In this area we know that competition has driven

efficiency of costs and solutions, and has also significantly increased the level of service received by customers. We believe that retaining competition and choice for customers who are seeking to connect to networks is of paramount importance as the market in this area has developed and matured across both gas and, more recently, electricity.

In general, we think that the circumstances where a procurement or open book contracting model will have cost control benefits over ex ante incentives are more limited. In these cases there may be less ongoing competitive market pressures, such as those that independent network operators, subject to relative price control at the efficient frontier, face. We think that it is possible that for some high value, discrete pieces of network that a tendering or procurement exercise to relieve constraints may have advantages but where the operation and maintenance of these pieces of network lies with the licence holder then it is possible that requiring the network companies to run this tendering exercise may be less complex and deliver the same benefits.

Q.4. What is your view of the options identified for simplification of incentive regulation? What would be the benefits and costs by comparison to the approaches used in RIIO-2?

Our view is that the options for simplification of incentive regulation represent the most appropriate way for Ofgem to regulate energy networks. We agree that some of the measures and mechanisms which have developed throughout the RIIO period have led to overly onerous or inefficient ways to administer ex-ante incentive regulation but, overall, it likely represents the most effective method of monitoring and regulating networks in the long-term in interests of consumers. It is also the least inhibitive route for Ofgem to regulate networks as it allows or elements of the other archetypes that Ofgem have identified to be used for separate areas of network activities.

We believe that ex-ante cost assessment (something similar to RPI-X regulation) is particularly useful for day-to-day activities such as managing and maintaining the existing network. Given the breadth and complexity of the transition to net-zero it is likely that simple model to monitor these activities will strike the right balance between ensuring network companies deliver efficiencies whilst being an efficient and low-cost regulatory framework. We have no concerns with an ex-post productivity-based incentive to be included in monitoring and managing the outputs of this type of activity.

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

Ex post monitoring would be well suited to the incremental, high volume, well-understood types of activities that Ofgem has identified in the consultation. This might include incremental reinforcement of existing distribution or primary substations which are lower down network tiers. We recognise the objection that this type of regulation tends to lead to capital solutions to solve problems/constraints but it is likely that the long-run costs of capital solutions for replacement and reinforcement of network assets which are lower down the voltage tiers will be lower than other, operational solutions given the rate and scale of electrification required to meet net-zero.

Q.6. What are the benefits and costs of this approach for Electricity Transmission by comparison to an evolution of the approach in RIIO-2, and what are the implementation barriers?

The benefits of this type of approach is that it allows for a more flexible approach to cost and output control. Utilising a variety of archetypes depended on the type of activity for transmission operators should allow for the most efficient and effective regulatory framework to be applied per activity.

Although this approach is likely to be more efficient in the long run, additional costs could arise in administering a multi archetype control where the approach to be taken is not well documented, clarified with industry and stakeholders, and easy to understand. If this is the case, then it may also present as risk to investors and lead to increased financing costs.

Q.7. What is the potential for Electricity Distribution planning and commissioning to move to an alternative model by the end of RIIO-2, and what might be the benefits and costs of doing so?

It is difficult to envisage, at this stage, a scenario where the local planning institutions play as big a role in the development and planning of the distribution system as they might for the transmission network. Distribution networks are more likely to be impacted by new connections which drive lumpy increases in overall system capacity and the breadth of these connections will make it difficult for any central body to be fully involved in the planning of distribution systems. There may be particular pieces of network or projects where an alternative model is suitable but this is likely to be limited to higher voltages where there is a need to resolve a specific, high value constraint.

As we have mentioned in our answers to previous questions, it is important that the regulatory framework does not inhibit the development of competitive, innovative solutions at the local level. There is an existing competitive market for providing connections and there is a developing market for the provision of local flexibility and aggregation for consumers. These are two examples of where competition can reduce the need for regulatory intervention and allow customers to determine the most appropriate solution based on the value that they create. Where such value is being created by and for customers then an alternative regulatory framework should be cognisant of this and not seek to undermine or inhibit it.

Q.8. What is your view on the most effective approach to regulation of Gas Distribution and Transmission beyond RIIO-2? What would the benefits and costs of moving to a simpler approach to regulation of the ongoing costs of operating and maintain the network.

The challenges that are face in gas transmission and distribution are a once in a generation change to either repurpose or decommission the network. In electricity, it is fair to assume that there will be greater electrification of heat and transport and so the direction, if not the path, is known. In gas the future is less clear at this stage and may well be a combination of those two eventualities. Ultimately, the price control and regulatory framework needs to be able to account for very different outcomes for consumers whilst still protecting those consumers from

excessive costs and ensuring that the investment and capital required to fund changes to the gas network is available.

The uncertainty around repurposing and decommissioning may lend itself to ex-post regulatory control to ensure that the networks have sufficient flexibility to respond to the needs of their customers but be held accountable for their cost and delivery performance.

Arguably a greater challenge for gas distribution and transmission networks is the recovery of the costs allowed through this regulatory framework. Although this does not directly form part of this consultation it is important that Ofgem recognises that the current cost recovery mechanisms (transportation charges etc.) for gas networks will need to evolve to reflect changes in the customer base and customer requirements.

Q.9. Should there be a shorter-term price control in gas distribution and/or gas transmission, and how could this work in practice?

We understand Ofgem's consideration that it is still unclear on the path of decarbonisation and the extent to which the existing networks will need to be repurposed for hydrogen. Indeed, we recognise this as a problem that it likely to exist well into the next price control period (if periodic reviews are retained). If there is clarity that the archetype(s) which are chosen will be able to deliver the necessary flexibility to account for all scenarios, then we believe that the revised framework could start for gas transmission and distribution in 2026. However, if there is any doubt, or the alignment of the distribution and transmission price controls allows the FSO and other organisation to effectively co-ordinate activity then we would have no objections to the current framework being extended for two years.

Q.10. Would there need to be any changes to maintain a stable and consistent financial framework if we were to make greater use of different regulatory archetypes, and if so, what would those changes need to be?

Ofgem is consulting in changes to the regulatory frameworks as a result, at least in part, of the rate and scale of change in the energy networks required to facilitate the transition to net-zero. Inherently, change is likely to reduce certainty for investors and may lead to increased financing costs. The method by which Ofgem should address this will depend largely on the archetypes which are used. Given that Ofgem is considering utilising multiple archetypes for different types of activities it may be appropriate for different financing arrangements to be secured for each of those activities and archetypes. For example, BAU and core costs associated with operating a network are largely fixed and well understood so the costs and financing associated with these activities may attract an expected return which reflects the relative stability. Where costs are less certain it is inevitable that investors will seek to see this uncertainty reflected in their expected returns. By ring-fencing activities, Ofgem will be able to set effective and fair financing regimes to attract the required investment into energy networks whilst ensuring that customers' costs are minimised.

Q.11. Do you have any views on our proposed analytical approach?

We are generally supportive of Ofgem's analytical approach. Ultimately the costs and savings which are incurred as a result of the change in approach to the regulatory framework are likely

to be borne by customers and so Ofgem must put consumers at the heart of any approach to determine a change away from the counterfactual.

We do, however, think that it is important, in understanding the impact to consumers to understand the impact to the range of industry participants that changes to the existing framework may have. These might be indirect consequences of changes brought about through regulatory frameworks but they could negatively impact outcomes for consumers in other areas of the energy market and so it is important that the analysis of the impact of consumers considers a wide range of views and stakeholders.