

Decision

Open Letter on Future of Gas Price Controls

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The Future Systems and Network Regulation (FSNR) consultation, published in March 2023, covered different options for network price controls under a transformation landscape towards Net Zero. This document aims to provide industry with early clarity on our current thinking in relation to the future price controls for gas transmission and distribution networks.

Our approach will be to develop a medium-term ex-ante price control for gas networks, starting in 2026. This letter explains how we arrived at this conclusion, and indicates the next steps in the process, in order to help gas network companies to start planning for the next price control review as effectively as possible at this stage.

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Introduction

The Future Systems and Network Regulation (FSNR) project looks at what adaptations may be needed in the existing network regulation regime in Great Britain to facilitate a Net Zero transition. In our March 2023 [consultation](#) we raised the option of rolling over the existing gas price controls by two years, to 2028, given the existing uncertainties impacting the sector and future developments for gas networks. We invited views on whether there is sufficient merit in this approach, establishing a streamlined short-term price control.

We conducted analysis to understand the key trade-offs of taking this decision, more detail of which can be found in the later sections of this letter. It is our view that the costs and risks of implementing a 2-year rollover are larger than the risk mitigation achieved as a result, and that a better solution is to implement a medium-term streamlined ex-ante price control, with the enduring framework being designed to start at the end of the next price control period.

This approach aligns with all four objectives within Ofgem’s consumer interest framework¹: Fair Prices, Quality & Standards, Low-Cost Transition, and Resilience. By implementing a streamlined but sufficiently rigorous price control, we ensure best value and quality of service for consumers, while keeping the framework flexible to adapt quickly to the needs of the net zero transition.

Our decision-making process

Table 1 shows the key stages in our decision-making process related to the future gas network price control.

¹ The consumer interest framework was included in the consultation for the [Forward Work Programme 23/24](#).

Table 1

Date	Stage description
29/09/2022	Stage 1: FSNR Open Letter
31/10/2022	Stage 2: Responses to Open Letter received
10/03/2023	Stage 3: Consultation on frameworks for Future Systems and Network Regulation issues
April-May 2023	Stage 4: Workshops and bilateral meetings with gas network companies and relevant stakeholders to understand practicalities for the next gas network price control
19/05/2023	Stage 5: Consultation close
26/07/2023	Stage 6: Open letter on decisions on future gas price controls (this letter)
Autumn 2023	Stage 7: Framework decision
By end of 2023	Stage 8: Gas methodology consultation

General feedback

We believe that consultation is at the heart of good policy development. We are keen to receive your comments about this report. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall quality of this document?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Are its conclusions balanced?
5. Did it make reasoned recommendations?
6. Any further comments

Please send any general feedback comments to stakeholders@ofgem.gov.uk.

1. Background and stakeholder input

This section states the reasoning behind considering the option of a 2-year mini price control for the next price control for gas networks, and summarises the main responses received from stakeholders for the two relevant questions in the March 2023 FSNR consultation.

- 1.1 The RIIO-2 network price controls for electricity and gas transmission and for gas distribution networks will run until March 2026, and for electricity distribution the price control will run until March 2028.
- 1.2 In our FSNR March consultation, we discussed the option of starting one or both of the next full gas networks (transmission and distribution) price controls in 2028, with a two-year mini price control in advance of that. The key considerations included the potential need:
 - (a) To address uncertainty about the future of gas networks, driven largely by key government decisions, notably the decision on hydrogen for heat.
 - (b) To allow time for strategic planning to mature and achieve alignment between gas and electricity distribution price controls, facilitating better whole system planning at the local level.
 - (c) To provide more time for a more fundamental review of price controls and develop a new approach, should it be needed to mitigate specific risks related to gas network regulation.

Stakeholder input

- 1.3 The questions included in the consultation are listed below:

Questions

- Q8. What is your view on the most effective approach to regulation of Gas Distribution and Transmission beyond RIIO-2? What would be the benefits and costs of moving to a simpler approach to regulation of the ongoing costs of operating and maintaining the network?**
- Q9. Should there be a shorter-term price control in gas distribution and/or gas transmission, and how could this work in practice?**

- 1.4 On **question Q8**, stakeholders broadly agreed that archetype 2² was the best approach in the short term, with the principles of RIIO retained in a simplified framework.
- 1.5 GDNs agreed that the framework should have a reduced burden of annual reporting and a simplified business plan process. NGT welcomed that Ofgem recognised the difference between BAU and more uncertain investment opportunities.
- 1.6 A range of stakeholders agreed that archetype 1 could have a role in the medium to longer term. NGT and a GDN noted that a more agile, whole system approach was needed to unlock strategic investment for net zero.
- 1.7 A GDN did not see how decommissioning and repurposing fell under archetype 1, given the interrelationship with the existing network.
- 1.8 There was broad agreement that hydrogen is intrinsically linked to the future of the gas networks. NGT and ESB considered that the gas price controls should be linked to the development of hydrogen business models.
- 1.9 In relation to a 2-year price control, **question Q9**, responses were mixed. The arguments for a delay focused on benefits from aligning the gas and electricity frameworks to support a whole system approach and to allow time for some of the policy uncertainties to be resolved. The support for a delay was often heavily caveated that it should be light touch.
- 1.10 The arguments against a delay highlighted risks of disproportionate effort vs. benefits, resource challenges and the fact that the regulatory uncertainties were unlikely to be fully resolved within the extra two years.
- 1.11 In relation to the gas network companies, two GDNs supported the idea of a delay, and two GDNs on balance did not support it. NGT in general opposed a delay.

² We identified three Archetypes in the March 2023 consultation, with the purpose of providing a framework for discussion on the different types of price control models. We indicated that these Archetypes were not definite, independent, models, but they should instead be seen as “points in a complex continuum”. The three Archetypes are:
Archetype 1: Plan and Deliver. Needs are defined by a strategic planner.
Archetype 2: Ex-ante Incentive Regulation. This allows for some incremental evolutions from RIIO-style regulation.
Archetype 3: Freedom and Accountability. Increased ease of monitoring to allow companies bounded freedom in their choices and an “open book” approach.

2. Future requirements for gas network controls

This section sets out our analysis of the following areas:

- The key uncertainties around future investment in the gas networks, and the policy decisions required to resolve these.
- The role of whole system planning in determining investment needs.
- The expected makeup of totex in the next price control period.
- Financing risks for the gas networks in light of these uncertainties

Uncertainty on the future of gas networks and regulatory milestones

- 2.1 Natural gas use is expected to decline in line with carbon budget targets. The main uncertainties concerning the future of the existing gas network are the speed and location of the anticipated decline in usage of natural gas, which will result in the phasing out and decommissioning of parts of the network; and the amount and location of repurposing of parts of the existing network for hydrogen. The overall balance, as well as speed and timings will be influenced by government decisions, including on the role of hydrogen for home heating. As noted above, the existence of this uncertainty was one key reason to consider a shorter mini-price control.
- 2.2 The new hydrogen regime is under development by Government and Ofgem, and because of that, is necessarily out of scope of this consultation and its response.
- 2.3 We have considered the likely transition timescales. Our understanding is that it is unlikely that major parts of the network will start to become de-energised in a systematic way before the early 2030s.
- 2.4 In the shorter term, we expect that gas distribution investment will instead be largely driven by the mandatory Iron Main Risk Reduction Programme (IMRRP), which is determined by Health and Safety Executive (HSE) requirements, and which is currently expected to be completed in 2032. Gas transmission investment is not based around repeatable activities in the same way, but even so we expect that a significant proportion of related costs will continue to be considered as core rather than transformative.

- 2.5 The current expectations are that there will therefore be operational continuity with past price control periods into the next price control. In addition, there are already mechanisms in place in RIIO-2 which allow the price control to change should the strategic context change, which we could replicate in the new price control.

Whole system planning

- 2.6 The creation of the Future System Operator (FSO) in 2024, and the subsequent development of its Centralised Strategic Network Plan (covering transmission) and the Regional System Planners (covering distribution), are expected to support and co-ordinate investment requirements across the networks. As the FSO establishes itself and develops its capabilities it could play a key role, including in planning the de-energisation of the gas networks and development of hydrogen networks. However, our view is that in the period out to 2031/32 any resulting requirements could be handled through re-openers.

Totex assessment

- 2.7 We consider that the nature of totex spend, which predominantly relates to repeatable and/or core activities, is unlikely to change significantly in the next few years following the end of the current price control in 2026. Customers will continue to pay for a network of a similar scale to that in place today. The nature of the operational risks may change, as the balance between gas and electricity continues to change, and longer-term direction for the network becomes clearer. However, we have seen no evidence to suggest that these operational risks could not be mitigated by an ex-ante regime comparable to RIIO-2.
- 2.8 Two of the distribution networks indicated that there is a case for an ex-post regime, in whole or in part, to give more flexibility to gas network operators. A move to an ex-post approach would result in a significant rebalancing of risk between customers and companies. Whilst there may be justifications for this, it would also introduce design challenges, in a sector where its assets are facing retirement or repurposing. In addition, changes to the framework will themselves introduce cost and uncertainty. On balance, we therefore think there are greater benefits in maintaining a consistent approach, rather than risk creating instability by making changes now that might not be suitable for the enduring regime.
- 2.9 We have therefore concluded that ex-ante regulation (Archetype 2) will continue to be the most suitable framework for gas networks for the next price control period. Cost assessment should reduce any risk of overinvestment and address

risks of increasing costs. Setting appropriate outputs, as well as minimum standards, will prevent deterioration of service levels.

- 2.10 We therefore propose to continue with an approach largely based on the RIIO-2 framework, but with simplification, to reduce administrative and regulatory burden, where appropriate. We discuss the implications for the process in the next section.
- 2.11 While repeatable/core activities represent the largest share of the gas controls, in developing the methodology for the next gas distribution and transmission controls, we will consider whether there should be a different approach taken to the remainder of costs (around 10%). For example, some larger projects, most likely for gas transmission, may be better suited for a form of Plan and Deliver regulation (Archetype 1).

Financing the gas networks

- 2.12 One challenge for the next period will be to address concerns about increased risk to the longer-term life of the gas network assets. We currently see two principal ways of mitigating this risk: through the choice of depreciation rates and regulatory asset lives; and through price control re-openers.
- 2.13 We consider that both will have a role in the next price control period. Our proposed approach is to both assess an accelerated depreciation schedule for the next price control period based on the best available evidence on the potential operational lives of the assets of the different networks; and to include a re-opener should there be reasons that assumptions change mid-control. Asset lives may well be lower than the current assumptions, and therefore we should consider this in setting depreciation rates in the next period, and this will be considered further in our consultation on methodology later this year.

Conclusion on the use of a medium-term price control, rather than a rollover

- 2.14 From the analysis we have carried out, we think it is unlikely that delaying the next gas price controls until 2028 by means of a rollover would provide significant benefits:
- We expect that any investment requirements, or changes to existing spending plans, that result from the 2026 decision on hydrogen for heating will be comparatively small in scale and of a type that can be handled under the

uncertainty mechanisms included in a 2026 price control, rather than requiring a new control to be designed around them.

- The timescales involved in the development and rollout of the FSO's regional plans means that there is no significant advantage to be gained in aligning the two distribution controls until after 2030.
- Since the activities and requirements to be included in the next price control (regardless of whether it starts in 2026 or 2028) will be broadly similar to those in RIIO-2, we do not think that having additional time to develop our thinking on FSNR would make a meaningful difference to our design of the control.

2.15 However, there would be significant drawbacks attached to it:

- It would require a simplified cost assessment approach, increasing the risk of inaccuracies which may be detrimental to both consumers and network companies.
- The complexity of the current price controls means that a shorter-term price control extension would still require significant resources to deliver, while simultaneously needing to start the design of the 2028 controls.

2.16 Therefore, we are of the view that **the next price control should take the form of a medium-term ex-ante framework**, which will build on the RIIO-2 methodology, and will commence in 2026. We intend to streamline the process where possible, retaining or removing existing outputs, and only introducing new ones where essential. We will adapt the existing cost assessment process as appropriate. We will consider whether there is a good reason to change the length of that price control from five years during the next stages of the process.

3. Next price control and next steps

This section briefly sets out how we will go about developing the next price controls. More details will be provided in the Framework Decision stage. It also includes initial steers on our expectations for company business plans, including on consumer engagement and the evidence to be submitted.

Process towards development of the next price controls

3.1 Based on this assessment of the approach to the next price controls for gas, we propose to take forward the design of a price control which is broadly similar to RIIO-2. This is now in development, and we will set out the detail of the new

price control framework for each of the sectors in the Framework Decision document to be published this autumn, but we have determined the broader outlines of our approach. During the next period, we do not expect any step changes in required spending on the gas networks that would justify new approaches to regulation.

- 3.2 Our starting point will therefore be the mechanisms applied in RIIO-2, and we will look to streamline where there is evidence of limited consumer value and simplification does not expose consumers to undue risk. We have been running a Lessons Learned exercise and intend to use its output to inform the design of the regulatory framework, including the potential to reduce the regulatory burden. Later this year, after the publication of the Framework Decision, we will consult on a methodology for the gas network price controls, where we will discuss where there are aspects of the regulatory framework that could be streamlined. This will include whether some of the outputs, incentives and uncertainty mechanisms could be removed without exposing customers and gas network companies to undue risk.
- 3.3 We understand that the gas network companies are already working towards the development of business plans for the next price control period. Our early view is that, under a simplified approach, there will still be a need for comparable cost forecasts to those required for RIIO-2 and that the gas network companies should continue to work towards development of those forecasts. We continue to consider that embedding the customer and stakeholder voice in price control processes is important and that enhanced stakeholder engagement can drive companies to improve the quality of their business plans, as was evidenced in RIIO-2. In our framework decision, we will set out our views on the appropriate process for enhanced engagement, including the extent to which the role of Customer Engagement Groups (CEGs) and User Groups (UGs) should be mandated by Ofgem. Our framework decision will balance the outcomes we are seeking to achieve (e.g. the submission of high quality cost forecasts reflecting a wide range of stakeholder interests) against possible simplification to reduce the regulatory burden of an onerous process.
- 3.4 We will seek to develop further how this would work in practice, including further engagement with the network companies, CEG and UG representatives and other stakeholders in the coming months.

- 3.5 We recognise that the gas sector has started its digitalisation journey, but still has significant progress make. We expect companies to be compliant with Data Best Practice in the next price control period and continuously collaborate across industry in co-creating a data sharing infrastructure. Digitalisation would form a key pillar for enabling whole system benefits and delivering consumer benefits. This aspect will continue to be developed as part of the wider digitalisation framework and that of the hydrogen regimes and will be part of the methodology considerations.
- 3.6 In parallel with the continued development of the gas price control and its methodology, as outlined above, we continue to work on the regulatory regimes for the electricity sectors. As outlined in the consultation, these networks will face significant and different challenges in addressing net zero. We will set out our approach to these in the autumn, as set out in the original timetable.