
Future Systems and Network Regulation: Framework Decision Overview

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This document sets out our decision on the overarching framework design for the network price controls for electricity and gas transmission and gas distribution that will run from April 2026.

In particular, it sets out our decisions on the specific points we sought views from respondents in our March 2023 Future of Systems and Network Regulation (FSNR) framework consultation.

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Table of Contents

Future Systems and Network Regulation: Framework Decision Overview	1
Foreword	4
1. Executive Summary	6
2. Introduction	8
Purpose of this document	8
Changing strategic context	8
Preparing the networks	8
What we consulted on	11
Process	13
3. Framework decisions overview	14
4. A streamlined RIIO	16
Principles of simplification	16
Simplified incentive regulation	16
Embedding the consumer and stakeholder voice	18
Business planning and price control process	19
Outputs, incentives and uncertainty mechanisms	20
Addressing uncertainty in the gas sector	21
5. Major projects regime	23
Strategic planning	23
Delivery of major new projects	25
Cost assessment, outputs and incentives for major new projects	28
6. Digital and data sharing requirements	30
Overview of digitalisation within the energy sector	30
Development of a data sharing infrastructure	31
Implications of digitalisation for price controls	32
7. Financial framework	34
8. Analytical framework	38
9. Next steps	40

Foreword

If there is one lesson to be taken from the energy crisis following Russia's invasion of Ukraine in 2022, it is the need to accelerate the shift away from fossil fuels to clean energy. This will help to reduce costs to consumers by breaking the link between electricity bills and gas prices; it will improve the security of supplies of energy; and it will help to protect consumers from the dangers of unmitigated climate change.

Without reform, the electricity grid at both the transmission and distribution levels, will become an obstacle to net zero. It is now imperative that generation and network investment are closely planned and coordinated; and that the electricity network is upgraded in anticipation of the significant numbers of low carbon assets needed to meet net zero targets for 2035 (a net zero clean power system) and 2050 (a net zero economy) being built and connecting to the network.

Earlier in the year, we consulted on a new approach to network regulation based on "system plans". Since then, the prime minister committed to the development of a strong spatial planning framework for the energy system, following recommendations by Nick Winser, the electricity networks commissioner. The purpose of this improved spatial planning is to coordinate generation, storage and network infrastructure in time and space, so that – as far as possible – when the wind farms and nuclear power stations and electric vehicles and battery factories are ready to connect to the grid, the grid capacity is already in place.

The need for such improved coordination is evident. Congestion has tripled in physical terms from 2010 to 2022, with the system operator in 2022 having to unwind 15% of all wholesale market trades in the balancing mechanism because they were physically unfeasible. It is a waste of resources (and a visible symptom of a lack of overall coordination) to connect significant new offshore and onshore wind capacity to the grid in Scotland, and then have to pay the relevant wind farms hundreds of millions in "constraint payments" to switch off because there is not sufficient grid capacity to transmit their energy to demand centres in the south of England.

System planning should allow us to move away from the approach taken in the past where market-led increments to transmission grid capacity perpetually lagged accelerating renewable generation connecting to the grid. In the future, we intend that programmatic grid expansion should occur in line with top-down system plans prepared by the Future System Operator (FSO), in anticipation of generation and demand.

While demand for electricity is likely to grow, demand for gas is likely to fall. It is therefore also important to consider the future regulation of the gas networks. In particular, we need to consider carefully how prices and charges should be set for gas

infrastructure ensuring both efficiency in future spending but also fairness in how different generations of gas customers pay for the sunk costs of historical investment in the gas grid.

The decision we are publishing today puts an essential building block in place – the framework for the design of future network price controls in the context of long-range system plans across gas and electricity. Reform of complementary areas – such as connections policies and network charging rules – is also underway. These reforms will be closely coordinated with the same objective in mind: acceleration of the shift to a net zero energy system at the least overall cost to consumers. This task is now vital and urgent. There is not a moment to lose.



Akshay Kaul

Director General, Infrastructure and Security
of Supply, Ofgem

1. Executive Summary

In this document we provide an overview of the framework decisions for the next price controls, focussing on the electricity transmission and gas network controls which will run from 2026-2031.

In this review, we have particularly focussed on the case for change, and whether the transformation of the energy system that is expected to occur in the period to 2035 implies a different approach to network regulation. We have found that the answer is both yes, and no.

First, we considered the approach to the investments associated with that network transformation. For electricity, this is likely to mean a sharp increase in the size of networks, and therefore in both the scale and pace of network investment. In addition, rather than being planned by Transmission Owners and Distribution Network Operators under a five-yearly planning cycle, transmission investments will be increasingly planned by the Future System Operator and distribution investments will be guided by a system planner.

Our regulation needs to change to reflect this: the timing of regulatory decisions, the approach to cost assessment, and the design of incentives all need to be different to the past, to ensure a coherent approach to meeting the objectives of fast pace, high quality and low cost for consumers. In addition to directly competing some strategic projects by the FSO, we propose to introduce a new major projects regime, building on learning from the ASTI (accelerated strategic transmission investment) regime used during RIIO-2. The new major projects regime will consider investments as they arise from strategic planning and in parallel, we will consider the effects on ongoing costs, outputs and incentives. We will design and adapt these processes so that Ofgem can ensure speed, quality and low cost are delivered for consumers without Ofgem approvals slowing down the process. We will develop the role of an independent technical advisor to ensure this ongoing assurance. For de-energisation of gas, it is too early to identify a comparable mechanism, and we will put in place a re-opener to make changes when necessary.

Second, we considered the approaches to ongoing costs. Overall, we found that the operation of the networks in these areas are unlikely to change significantly during 2026-2031 and therefore that much of our approach to regulation does not need to change. For gas, costs will continue to be driven by the need to maintain a safe and reliable network. For electricity transmission, ongoing costs are relatively small by comparison to major projects and the focus will be on ensuring that we can measure what is delivered in terms of a resilient and high-performing network. We therefore propose to use an approach comparable to RIIO-2, but with simplification where possible

to reflect lessons learned from RIIO-2, and the separation of the major project's regime. We will therefore call this price review RIIO-3.

Next, we considered the impact of digital transformation in the energy sector. We are concerned that this may not happen quickly enough without co-ordination, and without incentives on the companies to deliver the changes needed. We found that there are important benefits for the wider energy system and in terms of effectiveness of regulation from accelerating the process of digitalisation, including for the monitoring of network company delivery and performance. The price control should facilitate these changes.

Finally, we considered the financial framework. Although the balance of risks may change over time, we found that there were significant benefits to investors from continuing with a fixed five-year period for assessment of the costs of financing network companies. We have decided that the setting of an appropriate allowed return on capital and the assessment of financeability should be conducted as part of the five-year RIIO-3 period. We expect to set the allowed return on capital in line with the recommendations of the 2023 UK Regulators' Network Guidance. Within this, we will be able to consider the risks attributable to electricity and gas in how we measure the sector-specific elements of the cost of capital, including beta.

The rest of this document provides an overview of our framework decision, including our decision on each of the questions we raised in our March consultation on the future of systems and network regulation. It should be read alongside the Core Document, which provides a full summary of the conclusions of each of the five workstreams that we took forward over the summer, including stakeholder feedback, and our views on approaches to be taken forward in the RIIO-3 methodology consultations.

2. Introduction

Purpose of this document

- 2.1 In September 2022 we published an open letter setting out that we would be undertaking a review of the existing network regulation regime.¹ Following the open letter, in March 2023 we published our consultation on frameworks for future systems and network regulation ("the consultation").²
- 2.2 In the consultation we set out the combination of changes in the energy system which together required us to review how price controls are undertaken to determine whether these factors merit large-scale change in our price control frameworks, or whether we can rely on evolutionary change.
- 2.3 This document sets out our key decisions on the overarching framework approach for the next gas transmission (GT), gas distribution (GD) and electricity transmission (ET) network price controls which will be implemented from 1 April 2026, taking into consideration responses to our consultation and subsequent workshops, and sets out the next steps for the development of methodologies and processes for the next GT, GD, and ET price controls.
- 2.4 In reaching these decisions on the overarching frameworks, we have considered all consultation responses and stakeholder feedback received in response to our March 2023 consultation and workshops held subsequently. Our detailed reasoning, including our responses to the questions we asked in the consultation is set out in the accompanying Future Systems and Network Regulation Core Document ("Core Document").

Changing strategic context

- 2.5 This section summarises the energy system transformation which prompted our review of the existing network regulation regime.

Preparing the networks

- 2.6 The urgent energy system transition is underway and being driven by the UK, Scottish and Welsh Governments' legislative commitments to net zero and the policies underpinning it. The depth and speed of elements of the transition are uncertain, which translates into challenges in managing energy system changes

¹ [Open Letter: Future Systems and Network Regulation | Ofgem](#)

² [Consultation on frameworks for future systems and network regulation: enabling an energy system for the future | Ofgem](#)

to the location of electricity generation, increased electricity demand and a decline in natural gas demand.

- 2.7 We also recognise the significance of climate change in exacerbating extreme weather events and the importance of future energy systems being developed with acceptable levels of resilience against these events.
- 2.8 The energy system transformation needs to be supported by networks playing a key role – which means investing, upgrading, and relocating capacity, and reconsidering the use of the existing network.

Future of electricity

- 2.9 Delivering new and upgraded networks in the right place, at the right time and at low cost while protecting the interests of existing and future consumers, will be the key challenge for economic regulation of electricity networks.
- 2.10 There will be large amounts of new and differently located sources electricity supply to meet governments targets for a decarbonised power sector. These will require new transmission networks. There will also be demand increases as the economy increasingly electrifies. This will be driven and shaped by consumers' choices and behaviour, businesses, local communities and regional councils. New infrastructure will need to be ready to meet these evolving demands.
- 2.11 The change requires holistic planning to drive strategically planned upgrades, anticipatory investment and reform to the way assets are connected to the network. The Strategic Spatial Energy Plan (SSEP), Centralised Strategic Network Plan (CSNP) and regional system planners,³ all of which are currently in development and will be implemented from 2026 onwards, will be key to achieving this.
- 2.12 The decisions we implement in the next price controls to manage these challenges, including the decisions on the overarching framework set out in this document, will fundamentally define the GB network into the 2050s and beyond.

Future of gas

- 2.13 In gas, we face the opposite challenge in managing the declining use of the network due to the expected reduction in gas usage for power generation and electrification of some current gas demand. The speed and location of this transition are uncertain.

³ Exact title to be confirmed

- 2.14 The cost of existing assets being shared across a declining number of consumers in a fair manner, and how decommissioning and/or repurposing of the gas network is carried out efficiently are key challenges for economic regulation of gas networks.
- 2.15 The role of hydrogen is currently uncertain. Government considers that a regulated asset base (RAB) will likely be the most suitable regulatory model for a hydrogen network in the long term. Hydrogen networks and their regulation have been outside the scope of this particular review, but these changes will form an important context to decisions on gas networks beyond RIIO-2.

Benefits of whole system planning

- 2.16 Coordination between gas and electricity, transmission and distribution, and between energy networks and other parts of national infrastructure will play a vital role in enabling the energy system transformation needed at low cost.
- 2.17 A whole-system approach will reflect how supply changes both spatially and temporally. It will also take into account the timing of the transformations so that electricity networks can cope with new patterns of energy flows.
- 2.18 Institutional mechanisms which will deliver strategic energy system plans are being developed by government, Ofgem and the Future System Operator. These will enable actors across sectors and at all levels to work towards a common roadmap towards net zero.
- 2.19 The benefit of integrated and strategic thinking will be a cheaper, more secure and a more resilient route to net zero, with infrastructure delivered at the pace required.

Digitalisation

- 2.20 Energy sector digitalisation could enable transformational system-wide benefits such as cost savings (through optimal system maintenance and asset health, resilience, planning and operation), more agile regulation (reduced information asymmetry and seamless regulatory reporting) and a just cost-effective transition to net zero (identifying and helping vulnerable consumers).
- 2.21 Developing digital capabilities across network companies and Ofgem will underpin the future regulatory framework. The next price control period will be critical in developing and utilising the right tools and enabling this digital transformation to occur in practice.

What we consulted on

- 2.22 In light of the scale and range of factors affecting the future development of GB's gas and electricity networks, we have taken steps to consider the most appropriate regulatory framework for the challenges and opportunities that lie ahead.
- 2.23 Our March 2023 consultation detailed three archetypes we intended to assess against the status quo as part of the consultation phase of the review and in considering the case for change away from the model used in the current RIIO-2 price controls:
- Plan and Deliver (Archetype 1): relies on information asymmetries being reduced through the needs being defined by the new strategic planning processes, with economic regulation taking advantage of this to make intelligent use of competitive tendering or other forms of efficient procurement to ensure customers benefit from low costs.
 - Ex ante Incentive Regulation (Archetype 2): allows for incremental evolution from RIIO-style regulation. This archetype is most familiar in GB.
 - Freedom and Accountability (Archetype 3): relies on increased ease of monitoring to allow companies freedom in their choices, where companies pass costs through where they can demonstrate ex post that expenditure contributes to an agreed plan to achieve net zero objectives at low cost.
- 2.24 The consultation introduced alternative framework options which combine these archetypes for each sector, noting that these could be more relevant beyond RIIO-2 due to the changing landscape presented by institutional changes (namely the FSO), and opportunities for smarter, more flexible regulation aided by leveraging digitalisation. We did not state a preference or a settled view in the consultation but invited views from consultation respondents.
- 2.25 For ET, we assumed that activities can be separated into business as usual (BAU)/ replacement, reinforcement and new build. We invited stakeholder views on a proposed model:
- BAU and replacement - regulated using Archetype 2 whereby licensees' activities via submitted plans would be considered for simplification, including productivity-based incentives on ex post outturn costs, rather than allowances set on ex ante business plans.

- New build - delivered under Archetype 1 whereby the planning phase is dominated by new strategic planning institutions which would have responsibility of tendering processes for granular activities.
 - Reinforcement - uses both Archetype 1 and 2. For smaller discrete projects, licensees' engineering justifications and associated business plans are evaluated, possibly with an iterative process between the licensee and the planner.
- 2.26 We sought views on the practicability of activity separation, what would be needed to have planning institutions acquire the right capabilities to perform the roles envisaged and whether a move away from the RIIO-2 approach would give way to unintended consequences.
- 2.27 For GT and GD, we assumed activities can be separated into BAU/ replacement, decommissioning and new build. We invited stakeholder views on a proposed model:
- Replacement/ BAU - carried out by a combination of the licensee and HSE for the Iron Mains Risk Reduction Programme (IMRRP). An option for related ongoing expenditure would be moving towards ex post productivity-based incentive mechanisms (Archetype 2).
 - Decommissioning and repurposing - plan and design phases are operated under Archetype 1 whereby the FSO develops strategic plans with planning assumptions, locations and timetables. Given uncertainty around the costs of these activities, it could be operated as an ex post allowance and performance evaluation under Archetype 3.
 - New build - should new methane networks be needed, we proposed that this build would be regulated entirely under Archetype 1 on a case-by-case basis.
- 2.28 We also assessed the option of a short, simplified price control for GT and GD and the benefits this could bring. We decided against this option and set out our rationale in an Open Letter on the Future of Gas Price Controls in July 2023.⁴
- 2.29 Alongside alternative sector models, we consulted on whether there would need to be any changes to maintain a stable and consistent financial framework if there were to be greater use of different regulatory archetypes.

⁴ [Open Letter Decision on the Future of Gas Price Controls | Ofgem](#)

- 2.30 Our price control framework decisions resulting from the FSNR consultation are summarised in the chapter below, and more detailed rationale including our response to issues and comments raised by stakeholder responses to the consultation and in subsequent workgroups is covered in the Core Document.

Process

- 2.31 Following this decision on the RIIO-3 framework, we will develop the methodology that we will use to set the sector specific price controls during the remainder of 2023 and early 2024.
- 2.32 As we move into the sector specific methodology stage, we will ensure that we address specific challenges that may impact each of the sectors directly.
- 2.33 Decisions on cross-sector issues and design principles, including those related to the financial framework, will be discussed on a cross-sector basis with DNOs having the same opportunity as other stakeholders to input into the process.
- 2.34 Accordingly, we plan to consult on the methodologies for GT, GD and ET in December 2023 and to publish our decision on these methodologies in Spring 2024, alongside targeted Business Plan Guidance for RIIO-3 business plans due in December 2024.
- 2.35 The consultation process for the ED RIIO-3 price control which will come into effect in 2028 will begin in late 2024.

3. Framework decisions overview

- 3.1 A key element of the review of the case for change away from the RIIO model was considering whether the alternative options proposed in our consultation could deliver additional benefits over and above an evolution of RIIO-2.
- 3.2 This framework decision presents the trade-offs in our decision-making across the following key price control review areas:
- The benefits of using fixed periods (e.g., the 5-year control for RIIO-2) and whether these could keep up with the pace of change required.
 - Whether the RIIO toolkit would be dynamic enough to bring forward higher value, lower volume strategically planned transformation – and would drive network companies to focus on the big tasks at hand that would deliver consumer benefits.
 - The complexity of adapting the RIIO-2 approach and whether this would create incentives that unintentionally optimise the wrong behaviours and impose costly monitoring mechanisms for regulator and companies to track outcomes.
- 3.3 The outcome of our review and our overarching decision on the framework for the GT, GD and ET price controls from April 2026 is that these will resemble an evolution of RIIO-2 for ongoing activities, largely using the "Incentive Regulation" Archetype, and will be called RIIO-3. This decision has been informed by a wide range of stakeholder consultation responses and further feedback at working groups.
- 3.4 Alongside the development of RIIO-3, we will implement a parallel regime for the review of major projects that are needed to meet the strategic challenges and where the timeline for decision-making will not necessarily fit with that for a RIIO-style price control. These will follow a model closer to the "Plan and Deliver" Archetype. At this stage, the sector where we have identified this as a priority is ET. Once government decisions are made on the future of hydrogen for heating, we will revisit the appropriate form of regulation for any decisions to make structural changes to the gas networks.
- 3.5 Based on extensive engagement, our review concluded that the current RIIO-2 broad economic framework remains appropriate for ongoing costs, outputs and incentives. We see simplification as a key focus for RIIO-3 and we will seek to reduce the regulatory burden by streamlining the process, where it does not expose consumers to undue risk. This will be underpinned by digital infrastructure

and supported by enhanced levels of regulatory monitoring of delivery and performance.

3.6 Our review also considered that for RIIO-3, we expect network companies to deliver the following outcomes:

- **Infrastructure fit for a low-cost transition to net zero:** Network companies must facilitate a low-cost, environmentally sustainable, low carbon energy system that enables the transition to net zero, with infrastructure built at pace and fit for the long-term future.
- **Secure and resilient supplies:** Network companies must deliver a safe, secure and resilient network that is efficient, data rich and responsive to change. Consumers should have access to supplies that are resilient to physical, financial and cyber shocks.
- **High quality of service from regulated firms:** Network companies must deliver a high quality and reliable service to all consumers and network users, including those who are in vulnerable situation.
- **System efficiency and long-term value for money:** Network companies must deliver an efficient cost of service, minimise the costs to consumers of system transformation and ensure consumers and network users get a fair deal.

3.7 This document sets out our detailed reasoning, including responses to the questions we asked in the consultation and our reasoning for adopting a particular approach.

4. A streamlined RIIO

Principles of simplification

- 4.1 We recognise that a good price control framework is one that is smart and adaptable, that protects existing and future consumers, delivers appropriate returns for investors, while being proportionate and avoiding unnecessary regulatory complexity. We also recognise that good price control design incentivises the behaviours we wish to promote of cost effectiveness and acting in the long-term consumer interest.
- 4.2 We have undertaken a review of the key price control building blocks with a view to evolve and simplify the current RIIO-2 approach across all sectors where appropriate and where it does not expose energy consumers to undue risk.
- 4.3 Our review has identified some clear actions that can achieve simplification and streamline processes. In other areas, we consider that an evolved RIIO-2 approach remains appropriate.

Simplified incentive regulation

- 4.4 The March consultation considered whether further increases in complexity to adapt the RIIO-2 incentive regulation approach to the challenges of the transition would be practicable. It also asked about the benefits of a move to ex post regulation. Questions 4 and 5 asked:

Q.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 used in RIIO-2?

Q.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?

- 4.5 In the consultation, we identified the possibility that some activities could be regulated using a simplified incentive regime, potentially with greater use of ex post, where there was evidence that these activities were clearly separable and where the use of ex ante incentives was hard to implement reliably.
- 4.6 We found that there was a risk that a RIIO-2 approach would not be sufficiently agile to address some of the changes that might be needed to reflect the development of the strategic plans (SSEP and CSNP) and associated enabling works. As discussed below, we have decided that the regulatory treatment of major, strategic projects can be dealt with separately from ongoing costs. **We have decided that changes in costs related to large, strategically important investments can be addressed through a targeted regime.**

- 4.7 In respect of ongoing costs, we considered different options to implement alternative models with a primary focus on approaches which would significantly increase the use of ex post review to allow companies more flexibility in a period of transition. Overall, based on the evidence received, we found that incentives would be weaker, and it is therefore likely that costs would be higher. Stakeholders also highlighted that companies and their investors generally preferred the consistency and therefore greater certainty of a regime based on incentive regulation.
- 4.8 We found that there are greatest benefits to a flexible ex post regime where upfront identification and measurement of activities and costs is challenging, and where there are benefits from allowing companies greater freedom to make investments at pace, without upfront regulatory review. The activities that we identified in this review as appropriate for such a purer ex post review appear to be limited mostly to mid value projects where network companies would be able to evidence a clearly definable scope/driver, but where costs are hard to measure up front. We found this could be best addressed through an evolution of the uncertainty mechanisms (UMs) applied in RIIO-2.
- 4.9 Based on our analysis and stakeholder feedback, we have not found other circumstances relevant to the ongoing operation of existing electricity or gas networks where purer forms of ex post regulation would be more effective at incentivising cost efficiency and innovation than the current RIIO framework, ie ex ante cost assessment with UMs that adjust ex post for changes in costs during the period. We did not find the benefits from an ex post regime, such as simplification or greater flexibility for network companies, would be significant enough to overcome risks associated with a move away from a consistent and well-understood framework.
- 4.10 We also considered whether simplification of cost assessment would be effective. We assessed whether this could be enabled by further separability of costs, including a split between different repeatable and non-repeatable costs and activities. Through the working groups with stakeholders, we concluded that this is unlikely to be effective, as there are significant overlaps between activities. Given these challenges, we have not found supporting evidence or stakeholder feedback for a move back towards a simpler form of assessment as used in early implementations of RPI-X.
- 4.11 In particular, we found that the objective of material simplification to the cost assessment process to reduce regulatory burden could not be achieved without introducing other costs. Based on our analysis, we found that if benchmarking or

other forms of cost assessment would still be required, as was done in the price controls immediately prior to RIIO, there would be limited room for simplification. If we were to go beyond this and implement a very simplistic version of RPI-X without cost assessment as used in the earliest price controls, customers would be likely to pay more, particularly to less efficient network companies.

- 4.12 We also considered an alternative productivity-based incentive which would be measured ex post. We found on the basis of consultation responses and feedback during working groups that there would be similar concerns to reverting to a simpler form of cost assessment, and also that because of its ex post nature, this alternative would carry a weaker cost efficiency incentive.
- 4.13 Therefore, from a cost efficiency perspective, and particularly in relation to ongoing costs, **for the next price controls we have decided to refine the RIIO model instead of moving towards alternative forms of regulation.** We consider we can continue to use cost assessment to protect consumers, while achieving our objective of simplifying the process. As we move towards the methodology phase, we will keep exploring alternative simplification opportunities in the cost assessment process and more generally on cost efficiency incentives, wherever possible.
- 4.14 Chapter 5 of the Core Document provides further detailed reasoning behind our decision, including more detailed responses to stakeholder consultation feedback.

Embedding the consumer and stakeholder voice

- 4.15 The FSNR consultation set out our plans to discuss the role of the consumer voice at different stages of the price control review process, and the implications for future regulation. To inform the review, Question 1 of the consultation asked:

Q.1. What should the role of the 'consumer voice' be and through what institutions and processes should it be channelled?

- 4.16 **We have decided the RIIO-3 framework should maintain a clear objective for network companies to keep stakeholders at the heart of their business planning and decision-making, and that we will evolve existing mechanisms.** However, our review of the RIIO-2 Enhanced Engagement framework has indicated that there is opportunity to streamline this framework for RIIO-3 and minimise duplication of activities, relieving some regulatory burden across the companies and the regulator.
- 4.17 We consider that a focus on three core elements of the RIIO-2 framework can deliver the same valuable outcomes in terms of driving the development of high-

quality business plans which take into account local and regional energy system needs. We have decided on the basis of further work and stakeholder feedback that this framework will consist of:

- CEGs (GD) and UGs (GT and ET), will evolve into Independent Stakeholder Groups (ISGs), which will provide challenge and scrutiny on network companies' business plan development and have a new role in providing similar challenge and scrutiny for ongoing delivery of these plans. They will also have a role in ensuring wider stakeholder engagement
- The Call for Evidence, which should be designed to ensure that all stakeholders have the opportunity to comment upon, flag support for, or raise concerns with companies' RIIO-3 business plan proposals to us
- An enduring role for ISGs following the price control setting process, given the expectation that price controls will evolve during the period. We will consider during the development of RIIO-3 how we can best enable stakeholders to play a role in ensuring ongoing delivery of plans.

4.18 We have decided to remove the role of the Challenge Group and Open Hearings from the framework for Enhanced Engagement for RIIO-3, based on our review of the RIIO-2 framework and taking into account stakeholder feedback on these elements which indicates that these are time-consuming and administratively burdensome components.

4.19 Chapter 2 of the Core Document provides further information and detailed reasoning for our decisions, including responses to stakeholder feedback.

Business planning and price control process

4.20 We did not explicitly consult on the business planning process for the next price controls but highlighted it as a key area of review as part of the lessons learned exercise on RIIO-2 and discussed with stakeholders as part of that review.

4.21 It is our intention to minimise and streamline the business plan guidance for RIIO-3, making it more targeted with the aim of driving a higher degree of consistency and comparability across companies' plans.

4.22 Given that the network company plans will be developed in parallel with strategic plans, and the first full cross-vector CSNP is expected to follow the conclusion of the RIIO-3 process, the context to business planning for a five-year price control period has changed. Network companies should be planning beyond the price control timetable. We will review the balance between data on actual and planned

investments and what supporting reasoning and evidence is needed to understand that data.

- 4.23 We intend to publish the final business plan guidance in spring 2024, with final business plan submissions expected in December 2024. Our intention is to remove the requirement for a draft business plan submission in 2024.
- 4.24 We will provide an updated and more detailed timeline of the business planning process as we progress through the methodology stage.

Outputs, incentives and uncertainty mechanisms

- 4.25 We did not ask a specific question on the role of outputs, incentives and uncertainty mechanisms in the consultation, but highlighted that our lessons learned review of RIIO-2 would consider the price control review process including outputs and incentives.
- 4.26 We consider on the basis of consultation responses and working group discussions that our existing approach to setting outputs and incentives is effective in specifying what we expect network companies to deliver and holding companies accountable for delivering value for money. However, we note stakeholders' comments pointed us towards simplification and have proposed to streamline the suite of outputs and incentives by improving guidance on use of each of the mechanisms, including:
- a) Rolling forward RIIO-2 mechanisms that are working well and are reflective of the activities that network companies will deliver over the next price control
 - b) Removing RIIO-2 mechanisms that are duplicative, not outcome focused, have low materiality or where the consumer value is not clear
 - c) Narrowing the eligibility criteria for bespoke outputs and reputational incentives in order to raise the bar and limit number of bespoke proposals from companies.
- 4.27 We also found that more effective monitoring would be beneficial to improve the effectiveness of some of these mechanisms. Overall delivery against plans, but UMs in particular rely on the ability to monitor actual data on the same basis as it was forecast at the time of price control setting, so that allowed costs can be adjusted to reflect changes to investment requirements during the price control period.
- 4.28 Our analysis of the data that has been provided during RIIO-2 to date suggests that such monitoring will be supported by the improved digitalisation of the

networks that we propose as part of this review. Greater confidence in the quality of data should allow for the simplification of the process of defining and implementing uncertainty mechanisms. It should also help to address concerns that more flexibility provides opportunities for network companies to 'game' the price control by using information asymmetry to prioritise investment in lower-cost areas.

- 4.29 As part of our methodology, we will consider how to align the approach to outputs, incentives and uncertainty mechanisms with the delivery of associated improvements in data to allow effective monitoring. In particular, we will explore the opportunities for the use of uncertainty mechanisms to evolve based on a more digitalised data reporting infrastructure. In particular, we will consider whether better and more complete data available to Ofgem could reduce the need for more 'line-by-line' ex ante scrutiny and license requirements.
- 4.30 More information on our decision, including our response to stakeholder feedback is set out within Chapter 3 of the Core Document.

Addressing uncertainty in the gas sector

- 4.31 We expect strategic decisions to be made about the future direction of the gas networks during the RIIO-3 period and this creates a fundamental uncertainty over the longer-term regulatory framework. As a result, the March consultation discussed the option of starting the next full gas price controls in 2028, with a two-year mini price control in advance of that. We sought stakeholder views in response to Question 9 of the consultation:

Q.8. 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?

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

- 4.32 Our July Open Letter on the Future of the Gas Price Controls set out our view that the operational effects of strategic decisions on hydrogen, home heating and local energy systems will not be felt until the 2030s. We decided not to delay the start of a full gas price control until 2028 and instead communicated our decision for the GD and GT price controls to take the form of a medium-term ex ante framework commencing in 2026.

- 4.33 In the July Open Letter, we noted stakeholder concerns about increased risk to the longer-term life of the gas networks given likely longer-term decline in their use and suggested two principle ways of mitigating this risk: through the choice of depreciation rates and regulatory asset lives; and through price control re-openers. We will consider carefully how prices and charges should be set for gas infrastructure in RIIO-3 and beyond, ensuring both efficiency in future spending but also fairness in how different generations of gas customers pay for the sunk costs of historical investment in the gas grid.
- 4.34 For those elements of the price control where we continue to use incentives set using a periodic review, we found no evidence that the five-year period of RIIO-2 was not still appropriate. Five years remains a suitable period to review the effectiveness of decisions on the cost assessment, outputs and incentives described above, and to pass the benefits of outperformance to consumers. Our reasoning is set out in more detail in the Open Letter.

Length of price control

- 4.35 In the context of the overarching framework decision to progress with ex ante incentive regulation across all sectors in some capacity, **we have decided to progress with a fixed five-year price control period for RIIO-3**, in line with RIIO-2, for GD, GT and ET. We will review the form of the uncertainty mechanisms that are designed to allow us to be agile and react to government decisions on the future of gas during the RIIO-3 period. These may be needed either to support investment decisions or to protect consumers. In addition, we will review whether there are elements of the costs, outputs and incentive regimes that need to evolve to reflect the likely reduction in the use of gas over the RIIO-3 period.

5. Major projects regime

- 5.1 The electricity networks at both the transmission and distribution levels will require significant reinforcement and new network build over the coming years to avoid becoming an obstacle to GB achieving net zero. This will require improved coordination of company investment plans, a more strategic approach to new network build and a streamlined regulatory process which ensures Ofgem approval is not on the 'critical path'. We are seeking to design a regulatory regime to deliver this investment whilst ensuring delivery at pace, high quality and efficient cost.
- 5.2 The situation on the gas networks is less certain. If the net zero transition involves a significant role for hydrogen, then significant investment is likely to be required to adapt gas networks as well as build new hydrogen ones. This may also occur alongside a staged decommissioning of gas networks over the coming decades.
- 5.3 A key part of our FSNR review has been to consider how future price controls can best enable this investment on major new projects in the respective sectors.

Strategic planning

- 5.4 The FSNR consultation considered how the role of strategic planning may need to change during future network price controls. Question 2 asked:

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?

- 5.5 Responses to the consultation supported the view that an independent, cross vector view will be key in determining future network investment needs and that it was critical that the capability of the FSO continue to grow to support this function.
- 5.6 We consider that it is imperative that network investment is carefully planned and coordinated to align with the location of new low carbon generation, future increases in electricity demand and storage, and potentially the location of hydrogen infrastructure. The SSEP and CSNP will be key to facilitating this at the transmission level. We are developing options for regional system planners to take forward a similar role at distribution level during the next ED price control.
- 5.7 **We have decided that our regulatory design for funding major new network investments in the ET sector will use the CSNP as the 'needs**

case' to support funding requests. This will ensure that new investments are underpinned by an independent, cross vector view that has been developed transparently with the support of industry. It will also ensure that industry has confidence as early as possible regarding the future pipeline of new ET projects, which will be key to providing the licensees and supply chain with certainty to progress these nationally critical projects.

- 5.8 We expect that in the gas sectors our approach will differ slightly. In the methodology phase, we will consult on a position of using the FSO-led and regional system planner-led planning processes to support the needs case for new strategic investments and activities which will be compiled by the gas licensees and submitted to Ofgem for regulatory approval. A different approach is appropriate because the speed at which gas investment needs to be delivered may not be the same as in electricity and there could be greater uncertainty as to which investments may be required in the gas sectors.
- 5.9 Strategic planning will also play a key role in future ED price controls to ensure that local demand requirements for low carbon technologies such as electric vehicle charge points, distributed generation and storage, and heat-pumps can be connected as quickly as needed, and that there is a coordinated view with development of heat networks and where there is, or is not, a future role for hydrogen. As such, Question 7 of our FSNR consultation asked about the role of strategic planning in the ED sector:

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?

- 5.10 There was a broad consensus amongst respondents that for ED it is too early to make decisions on a potential role for different archetypes, given how recently RIIO-ED2 started. The benefits of the evolved incentive-based model for RIIO-ED2 are yet to be observed. Respondents, including all DNOs, questioned the value of whether early proposals, without adequate observation of the new counterfactual, can be meaningful at this stage.
- 5.11 **We are not deciding any aspects of the ED sector through this decision** but will continue to engage with stakeholders on the role of strategic planning in ED through the work that we are doing on Local Governance and the development of regional system planners. We will be issuing a consultation on these areas shortly following this publication. We will work towards a separate

framework decision on ED over the next year, drawing on the cross-sector themes identified by this Framework Decision.

Delivery of major new projects

- 5.12 Ensuring efficient delivery of the large amounts of network infrastructure that will be needed during the next few price control periods has been a priority throughout our review.
- 5.13 As discussed at paragraph 4.9 above, we have concluded that taking a wholly ex post approach to regulation is likely to result in higher costs to consumers in most cases. We consider that this equally applies to the delivery phase of major projects where we believe there remains significant consumer value in retaining cost incentives on TOs and to align their interests with customers. However, given the importance of advance preparation and procurement to deliver major projects effectively and efficiently and the extreme difficulty of setting 'efficient' costs for these activities up-front, we will incorporate aspects of ex post regulation - these areas are discussed further at paragraph 5.23.
- 5.14 The FSNR consultation asked about the role of competition and open book contracting in the delivery of large new network investment. Question 3 asked:

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?

- 5.15 There were mixed views from respondents on the use of competition. Some felt that broadened competition could have advantages for larger projects whereas others raised concern about how supply chain inefficiencies and difficulties could present barriers to creating effective competitive approaches. Concern was raised that in the context of global competition for access to supply chains, there would be a risk that introducing competition could inadvertently slow down infrastructure build (project by project as opposed to a programme of projects).
- 5.16 Multiple respondents set out that where assets cannot easily be separated for competition, or competition procurement itself causes delays or inefficiencies, ex ante allowances or open book approaches give more flexibility to licensees to deliver an interactive portfolio of projects.
- 5.17 On open book contracting some respondents argued that it should remain the responsibility of the network operator to determine the appropriate contractual framework for each project.

- 5.18 **Our decision is that competition 'for the market' should remain an option for delivery of large new infrastructure in future price controls, particularly in the ET sector.** This would likely involve open competition between bidders for the opportunity to design, build and construct new ET infrastructure. **Competition should be used where we can be confident that the use of competition will deliver benefits to GB consumers, including avoiding delays to project delivery.** We will continue to develop a regime for competition to the TOs, which will be used alongside evaluation of TO procurement to consider the extent to which the competitive model could become used more widely in future periods.
- 5.19 However, we expect that the large majority of projects will continue to be designed and procured by the existing TOs during the next period. Competition will still be able to deliver benefits to consumers through incumbent TO procurement via competition in the supply chain of the construction phase of the projects. Typically, this phase of projects represents the majority (around 70-80%) of the total cost. Our approach, which we set out below, is to ensure that we can enable consumer value in this context.
- 5.20 The FSNR consultation set out a potential model for ET whereby ongoing asset replacement and BAU work remained in the price control under an Archetype 2 framework and the large new build work would be progressed under Archetype 1. Question 6 asked:

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?

- 5.21 At a high level, the outcome of our review and consideration of consultation feedback is that RIIO-style ex ante regulation (in line with that of Archetype 2) is sufficiently adaptable to deal with the challenges associated with each sector, with some key modifications and considerations for the ET sector. Here, the approach to major project investment seeks to deliver both pace and cost efficiency using an adapted form of Plan and Deliver (Archetype 1).
- 5.22 For ET, we recognise that the totex spend for the next price control period and beyond will represent a very different mix to previous ET price controls due to scale and timings of investments required. Maximising consumer benefit from these new investments requires a regulatory regime that can optimise outcomes in terms of time, cost and quality of network infrastructure.

5.23 **Our decision for new investments on major projects, where project need is determined by the FSO, is to build upon the current Accelerated Strategic Transmission Investment (ASTI) process to provide staged approvals of major projects, with Ofgem scrutiny focused on reviewing implementation of effective procurement by the TOs.** This is detailed in the Core Document but in short, our decision entails the following:

- The need for large new ET projects will be confirmed by the FSO through the CSNP. We will develop a process for regulatory approval of the need for the projects that is embedded in FSO processes to avoid any delay caused by regulatory oversight.
- Prior to the establishment of the FSO, for projects in the RIIO-3 period that relate to the ESO's transitional CSNP, we will put in place an interim approach that mirrors as far as possible the enduring regime proposed for the main CSNP.
- Some projects will be directly competed by the FSO, and this process will be developed in parallel with the process for those projects delivered by the existing TOs. This will both allow for alternative delivery models where that is more efficient and provide additional data points for benchmarking the costs of TO-led projects.
- TO-led projects that meet need requirements will receive automatic funding for the costs of pre- and early-construction work needed to develop and start the project. These costs will be assessed on a simplified and largely ex post basis, subject to consistency with benchmarks across projects.
- Prior to moving into the construction phase TOs will be required to demonstrate efficient procurement.
- We will require the appointment of an independent technical advisor to provide assurance to Ofgem of effective design decisions and effective procurement and provide advice to support Ofgem's decision making. We will also require such a role to assure effective and timely delivery.
- As TOs finalise procurement for delivery of a project Ofgem will set target costs aligned with efficient procurement.
- TOs will also be required to connect to and use the data sharing infrastructure required by digitalisation, to assist strategic network planning and regulatory reporting.

- Delivery incentives will be embedded in the process to incentivise timely and high-quality delivery. We will also consider the use of behavioural incentives to promote a culture of working in customers' interests.
 - The financial framework for these large projects will not be set on a project-by-project basis but continue to be subject to the five-year review of the overall price control and include allowances to ensure that the TOs can expect sufficient returns to be able to raise equity.
- 5.24 This framework will cover the major projects that arise from the CSNP, in particular to ensure timely review points for major projects that require decisions by Ofgem outside the business planning timetable for the 2026-31 period.
- 5.25 In the next price control period, alongside investments in major projects that arise directly from the planning by ESO and FSO, we expect the TOs to undertake significant integrated regional or site-specific strategic investments designed to support the upgrade and growth of their networks. The effective review and implementation of these projects is expected to be critical to delivering the benefits of the major projects that result directly from strategic planning.
- 5.26 We will assess the most appropriate timing for business planning, needs approval and cost assessment for these projects as part of the development of RIIO-3. This will include the process by which the FSO provides assurance that any TO-led plans are consistent with its whole-system plans.

Cost assessment, outputs and incentives for major new projects

- 5.27 The effective regulation of major projects requires a change to the timing of project reviews, away from a five-year cycle and towards a responsive framework aligned with strategic planning (ie the three-year CSNP cycle). It also needs a change to the pace of need and cost assessment, and building these into price controls, to ensure that Ofgem's regulation does not 'get in the way' of timely delivery of the programme of investments required by the CSNP.
- 5.28 As part of ASTI, we have started to develop a new approach to cost assessment which will allow us to effectively review project cost forecasts quickly and to balance this need for pace with the need to protect consumers. We have concluded on the basis of stakeholder responses and our analysis that this approach should be evolved into the regime for future major projects. We propose that cost review should be focused on both efficient procurement and setting costs based on the outputs of that procurement. Alongside the effective monitoring of assets supported by digitalisation, this should allow us to set

efficient cost targets for the delivery phase of projects within the timelines of the procurement and delivery process. This should be feasible by running the delivery cost assessment in line with other project approvals and with support of the independent technical assessor.

- 5.29 For the earlier stages of investment, where cost risk is lower and there is greatest risk that a lengthy Ofgem process could translate into overall project delay, we intend to evolve the approach used in ASTI. This should allow network companies to recover actual costs incurred without an intensive ex ante review, subject to consistency with guidance, including comparisons of costs from other projects.
- 5.30 We considered the alternative of moving to an ex post regime for all cost review, which would be another way to ensure that the cost assessment process does not cause delays to the investment programme. Overall, we found that this would significantly risk cost overruns during the delivery phase. Supply chains are constrained, and there are important risks that this could result in pressures on costs, especially if TOs do not have any incentives to keep costs down. As with ongoing costs, we have concluded that, once the investment projects reach the stage that costs and outputs can be defined effectively, incentive regulation will be more effective than ex post in keeping costs down for consumers. This is discussed in more detail in the Core Document.
- 5.31 In parallel, we will review the approach to outputs and incentives used in RIIO-2, both for the purposes of simplification as discussed above and also as to whether they need to evolve to work alongside the growth in major projects. We will also review the design of uncertainty mechanisms that adjust cost allowances to reflect links between major project investments and ongoing costs.

6. Digital and data sharing requirements

Overview of digitalisation within the energy sector

- 6.1 Energy sector digitalisation can enable transformational system-wide benefits such as cost savings (optimal system maintenance, asset health, resilience, planning and operation) and more agile regulation (reduced information asymmetry and seamless regulatory reporting). It can contribute to a lowest true cost, just transition to a net zero power system by 2035, including by identifying and supporting vulnerable consumers.
- 6.2 This requires a fundamental digital transformation across the sector, from generation to transmission and distribution to end-use – clarifying terminology, ensuring interoperability, determining standards and developing distributed data infrastructure. This will bring system benefits, supporting network companies to address demand growth, tackle decarbonisation and improve resilience. The benefits of digitalisation are clear and have been since the publication of the findings of the Energy Data Taskforce in 2019,⁵ and the subsequent findings of the Energy Digitalisation Taskforce in 2022.⁶
- 6.3 In July 2021, Ofgem and the Department for Energy Security and Net Zero published our joint Energy Digitalisation Strategy,⁷ committing Government and Ofgem to a series of actions to support the digitalisation of the energy sector. We have been making good progress on delivering those actions, including the action to support the sector in creating an ecosystem where “digital services will make it easier for people to know what data exists and how they can gain access to it”. This decision document will make clear our intended next steps on how we achieve that vision.
- 6.4 Within the Energy Digitalisation Strategy, we also committed to creating an agile regulatory environment that builds digitalisation into regulatory frameworks. The prominence of digitalisation within the framework of the next price control period is further demonstration of the progress being made on digitalisation by Ofgem and licensees. We see a crucial role for Ofgem in helping deliver interoperability and coordination across licensees, ensuring digital products and services are not built in siloes.

⁵ [Energy Data Taskforce | A Modern Digitalised Energy System \(catapult.org.uk\)](https://catapult.org.uk/energy-data-taskforce/)

⁶ [Energy Digitalisation Taskforce publishes recommendations for a digitalised Net Zero energy system - Energy Systems Catapult](#)

⁷ [Digitalising our energy system for net zero: Strategy and Action Plan 2021. BEIS, Innovate UK, Ofgem](#)

- 6.5 We found that the key enabler for a digitalised energy system is the availability, access to and sharing of energy-related data. We consider this requires a common data sharing infrastructure for the energy sector, comprised of a trust framework, data preparation mechanism and data sharing mechanism. Developing this data sharing infrastructure will be critical and relies on a clear vision which identifies gaps, a roadmap with timings and delegation of governance and delivery responsibilities.
- 6.6 We will continue to support licensees to invest in their internal digital architectures, data platforms and data governance and standardisation. We intend this to be a continuation of the approach we took to RIIO-ED2 and the recent RIIO-2 Non-operational IT CAPEX re-opener decisions.

Development of a data sharing infrastructure

- 6.7 A common data sharing infrastructure will be needed to maximise the value of flexibility, strategic planning,⁸ regional planning⁹ and to establish a seamless, efficient data sharing protocol between Ofgem and licensees. A data sharing infrastructure needs to comprise three key elements: a trust framework, a data preparation mechanism and a data sharing mechanism. To fully deliver the benefits to consumers of the wider reforms to price controls, in particular that which we have concluded above, we envisage a data sharing infrastructure minimum viable product needs to be in place by the next price control period.
- 6.8 To build a data sharing infrastructure at speed, a clear vision is needed. This will require a co-created and coordinated roadmap (with timings), technical and relationship/stakeholder management skills and delegation of responsibility for delivery and operation.
- 6.9 Stakeholders and industry experts have called for a greater leadership role from Ofgem. **Therefore, we have decided that Ofgem should support the industry by developing the pathway for delivering a data sharing infrastructure.** This should include agreed common standards (technical and legal) and streamlined data sharing, while ensuring increased stakeholder engagement and essential cyber security.
- 6.10 Whilst some of this leadership is already demonstrated by our work on Data Best Practice, we will also focus on the early need for core data for regulatory purposes. This will enable development of an MVP in time for the start of the next

⁸ [Decision on the initial findings of our Electricity Transmission Network Planning Review - Ofgem](#)

⁹ [Future of local energy institutions and governance consultation - Ofgem](#)

price control. The next step of this leadership will be publishing a set of governance proposals for a data sharing infrastructure in Spring 2024.

Implications of digitalisation for price controls

- 6.11 In addition to the wider system benefits, data sharing infrastructure will present opportunities to reduce the regulatory burden whilst accessing granular data, thus reducing the administration burden for information sharing between regulator and licensees.
- 6.12 Access to up-to-date existing information held by licensees on assets, asset health and asset interventions is key to enabling a more streamlined RIIO process (for example through enabling some more flexible mechanisms, and also by use of existing data more directly), as well as ensuring that Ofgem can be confident that it has the best data to act in consumers interests. We have identified providing an exchange mechanism between Ofgem and licensees for this data as a key use case for a minimum viable product (MVP) of a data sharing infrastructure. We will therefore seek to develop an MVP for this purpose as a priority, alongside wider considerations on governance and principles.
- 6.13 **We have decided to require licensees to participate in such data sharing infrastructure, once operational, to enable the wider system benefits identified above. We have also decided that the identified base level data should be shared with Ofgem at the commencement of the price control.** We will consider this further in the development of RIIO-3.
- 6.14 Network and non-network stakeholders highlighted that licensees need to increase capacity and capability to exploit faster data transfer and greater data availability. We also recognise that these requirements will require investment from licensees. Alongside the development of RIIO-3, we will consider whether additional funding is needed in RIIO-2, to enable the development of the required infrastructure.
- 6.15 In summary, through this decision document, Ofgem is committing to:
- publishing an assessment of governance options for a data sharing infrastructure in Spring 2024
 - developing further details on the requirements for a price control use case of a data sharing infrastructure MVP, as part of the methodology phase
 - Working with industry to develop additional use cases for a data sharing infrastructure MVP, including options for delivery ahead of the next price control period

- Assessing options both for funding and incentives to deliver enhanced digitalisation as part of the price control structure.

7. Financial framework

- 7.1 The FSNR consultation considered whether changes to the financial and financeability framework would help facilitate the changing needs, objectives and regulatory mechanisms of the energy network sectors. Specifically, Question 10 of the consultation asked:

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?"

- 7.2 We have incorporated feedback on this question as well as feedback and decisions from across the FSNR consultation when deciding on a financial framework that will maintain investor confidence in the sector, support legislative commitments to net zero and continue to meet our primary duty to consumers.
- 7.3 We have carefully considered whether the growing use of Archetype 1 or 'Plan and Deliver' regulatory approaches which we have concluded should be used in setting allowances for significant additional investment required in the ET sector would affect the approach to the financial framework. We considered, for example, whether setting differential returns for these strategically important projects could either increase the availability of capital or be used as part of the incentive regime for effective delivery of these major projects.
- 7.4 There are theoretical reasons for setting returns on a more targeted basis or setting multiple returns across activities, where the underlying risk profiles are significantly different. However, in practice, we expect that any potential benefits would be more than offset by likely increases in costs and complexity and through constraints to effective implementation. On balance, we consider the evidence presented by consultation responses and during working groups and the analysis undertaken to-date, supports the ongoing use of a single calculated return on capital (at an appropriate notional level of gearing), applied across both existing RAV and new investment. This is consistent with the approach used in RIIO-2, including for the £10 billion of projects subject to uncertainty mechanisms in ET, and for the ASTI framework.
- 7.5 As a result of our finding that a single calculated return on capital remains appropriate, we have decided that:
- **When setting the allowed return on equity, we will continue to calculate a single allowance per licensee** (at the appropriate notional level of gearing). We will consider evidence of changes in the exposure to

systematic risk in each network type when estimating the appropriate beta in our cost of equity calculations. Subject to sufficient evidence, this may involve considering additional or alternative comparator data within our estimate of beta or may influence the time period of the beta data considered or point estimate used in our calculation. We will continue to use the CAPM model as the primary tool when estimating the cost of equity

- **When setting the allowed return on debt, we will continue to calculate a single allowance per licensee (at the appropriate notional level of gearing).** However, in setting our allowed return on debt we may update the cost of debt calculation approach used in RIIO-2 to reflect the increasingly differing quantum and pace of investment, as well as the findings of our Call for Input on inflation.

- 7.6 Since the launch of the FSNR consultation, the UKRN has published guidance for regulators on the methodology for setting the cost of capital.¹⁰ This guidance is the result of a request from Government, asking regulators to identify areas where there is already significant alignment in cost of capital methodologies and areas where further alignment could be achieved. As part of this process, Ofgem has committed to having regard to the recommendations in this guidance in its future price control decisions where this is permitted by its statutory duties and to deviate only where it considers there are good reasons to depart from these recommendations. As a result, we expect to incorporate the guidance recommendations into our methodology for setting the allowed return on capital. We consider these recommendations to be substantially in line with the approaches used in the RIIO-2 price controls.
- 7.7 We have also carefully considered the potential impact of our proposed changes to the regulatory regime on whether fixed five-year periods for the financial framework remain appropriate. It is likely that an increasing proportion of investment in the ET sector will be planned, assessed and actioned over time periods that do not exactly match the current 5-year price control review periods used to set allowed returns and assess financeability.
- 7.8 We recognise that there are potential benefits that may arise from changing the approach to setting returns and assessing financeability over periods that better match the planning, cost assessment and investment horizons of new projects. However, we see considerable downsides to such an approach. Moving to a

¹⁰ UKRN (2023), [Guidance for regulators on the methodology for setting the cost of capital](#).

bespoke approach that exactly matched these changing timeframes could not be accurately defined in advance, would not necessarily be practical or beneficial when considering appropriate returns on existing assets, would challenge the accurate consideration of the financeability of the licensee in-the-round and would risk significantly increasing the complexity within the price control setting process. It might also be less effective, as in practice network companies are financed as a single entity, including both assets-in-place and new investments, and therefore the data that we have reflects that overall financial risk profile.

- 7.9 On balance, it is our view that the timing of allowed returns and financeability assessments does not need to correspond exactly to the period used where cost allowances and investment planning may be better considered over longer or shorter time horizons.
- 7.10 A range of stakeholders have been clear that they see a need for enhancements to our approach to assessing financeability, such as increased sophistication and longer time horizons in our assessment. Network companies specifically suggested a need to better consider equity financeability or 'investability' to take account of unprecedented demand for new equity financing over the coming decades.
- 7.11 We recognise the financeability challenges highlighted by stakeholders during this consultation. While we continue to consider the overall financeability framework to be appropriate for the coming price controls, we agree with stakeholders that a broader assessment of 'investability' in addition to our traditional assessment of financeability may have merit. This is likely to be particularly important in the ET sector where there is likely to be a requirement for companies to seek additional equity investment to maintain appropriate levels of financial resilience while undertaking significant investment programmes. Our framework for RIIO-3 will need to appropriately consider any financing costs of attracting this amount of equity capital.
- 7.12 There may also be merit in assessing longer-term financeability (eg, beyond the length of the periodic review) if it helps to secure lower costs and access to wider sources of capital during this important phase of high investment need. In addition, any appropriate associated updates to financial resilience requirements will be considered with reference to the changing needs of the sector, relevant external evidence and a consideration of the RIIO-3 price control in-the-round.
- 7.13 As separately noted in the July Open Letter on the future of gas price controls, we do not currently consider there to be a need for additional returns on capital in

compensation for perceptions of increased risk in the gas sectors. However, we have noted that risk mitigations in the form of updates to regulatory depreciation and assets lives and/or through the inclusion of price control reopeners will be considered further in our consultation on methodology later this year. As noted in paragraph 4.33, we will consider carefully how prices and charges should be set for gas infrastructure in RIIO-3 and beyond, ensuring both efficiency in future spending but also fairness in how different generations of gas customers pay for the sunk costs of historical investment in the gas grid.

8. Analytical framework

- 8.1 The FSNR consultation set out our plans to assess the options on the future regulatory framework as they might apply in each sector against a counterfactual of the RIIO-2 framework with incremental change. We said we would need to demonstrate that any changes away from the RIIO-2 approach would be expected to deliver net benefits, having regard to the different objectives outlined in Ofgem's consumer interest framework.

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

- 8.2 Having considered the feedback provided to this question we have amended our approach to use a counterfactual of the continuation of the RIIO-2 framework as it currently exists.

Electricity Transmission

- 8.3 In developing our impact assessment we have made a number of assumptions to structure the quantification of the relevant costs and benefits.
- 8.4 For delivery costs we have assumed that efficiencies are achieved through the effective procurement process in which baselines are set by TO-led procurement but with oversight by Independent Technical Advisors (ITA), providing assurance to Ofgem that procurement and design choices are efficient. For supporting costs we assume that these are reviewed at an early stage through a less intense but more pacy process. We have assumed a cross-check against relevant benchmarks where possible.
- 8.5 For the costs of regulation we have assumed that this could result in some increase in costs through the operation of the ITA and enhanced Ofgem monitoring of projects, as well as through industry standardisation initiatives.
- 8.6 Based on our findings which are summarised above, we conclude that this package of measures will mean that Ofgem's benchmarking and monitoring-related activities can be delivered at a much faster pace than in the counterfactual. This should ultimately give rise to benefits to customers in the form of earlier delivery which should contribute to lower constraint costs and accelerated wider benefits including decarbonisation benefits.
- 8.7 Our assessment, which is described in the Impact Assessment, indicates that these benefits of increased pace significantly outweigh the increased costs of regulation. For ongoing costs, our finding is that an approach consistent with the

counterfactual (incentive regulation) remains the most appropriate in terms of the broad definition of the consumer interest.

Gas Distribution and Transmission

- 8.8 Our impact assessment for the Gas Distribution sector identifies the primary trade-off as being whether the benefits of regulation are high enough to address any costs that may arise.
- 8.9 We estimate significant benefits exists from benchmarking which are expected to far exceed the additional costs of regulation that benchmarking creates. In particular we estimate the increase in totex baselines for RIIO-GD2 arising from not carrying out a full benchmarking exercise for the gas distribution sector could be in the order of hundreds of millions. For gas transmission, the use of benchmarking is more limited, but we still consider that there will be some sufficient benefit from unit cost benchmarking.
- 8.10 By contrast, we consider there is limited benefit from moving towards a more flexible approach to operating the gas networks, in advance of strategic decisions from government on the future of the networks. We therefore propose to maintain incentive regulation rather than move to alternatives such as an ex post framework.

9. Next steps

- 9.1 Following this decision, we will engage network companies and wider stakeholders on sector-specific methodology development ahead of our December 2023 consultation.
- 9.2 The period of engagement will involve working group discussions across each sector on policy, cost assessment and finance, as well as a cross-sector working group on cross-cutting issues.
- 9.3 Engagement via these forums has begun already and will continue to inform our December consultation proposals. Working groups will continue through to spring 2024 to inform our sector-specific methodology decisions.
- 9.4 A key element of engagement will centre around the business planning process, including the development of business plan guidance and submissions of required data for business planning, the setting of the price controls and the development of the data infrastructure.