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Consultation on strategy for the next transmission price control - RIIO-T1 Overview paper December 2010

Dear Grant,

Thank you for the opportunity to comment on this consultation. This response is provided on behalf of the RWE group of companies, including RWE Npower plc and RWE Supply and Trading GmbH.

Undertaking the next transmission price control under the new RIIO regulatory framework will present challenges for all industry stakeholders. We have some concerns that Ofgem is proposing an overly compressed timetable and that the "fast-tracking" option merely diverts resources, as it is unlikely that any company will be in a position to take advantage of the option.

The overview and associated consultation documents describe the principal elements of the new framework, where the network companies will need to set outputs and secondary deliverables and set out how they will deliver them. While there may be a case for some well-justified anticipatory investment, any mechanism must mitigate the risk of asset stranding and imposing unnecessary costs on consumers. From our perspective, the interaction between outputs, incentives and uncertainty mechanism appears complex. We would be concerned if this complexity lead to volatile and unpredictable network charges.

Our answers to the detailed consultation questions are set out in Appendix 1, below.

We hope these views are helpful and if you wish to discuss any aspect of them in further detail, please do not hesitate to contact me.

Yours sincerely,

By email so unsigned

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APPENDIX 1: Consultation Questions

CHAPTER 1: Introduction

Question 1: Do you have any comments on the proposed process and timetable for the review?

Given the added complexity and lack of industry experience with the RIIO model, we are concerned about what appears to be a compressed timetable for the review. Although there are more scheduled stakeholder events than previously, there are fewer formal industry consultations and it is these consultations that provide allow stakeholders that are not immersed in the detail of the price control to gain an understanding of the overall proposals. We would welcome an increased level of written consultation.

CHAPTER 2: Context

Question 1: Do respondents consider there are any interactions with other policy areas that have not been highlighted in this chapter?

The *Gas Security of Supply Significant Code Review* may have implications for NGG NTS if the emergency cash-out arrangements result in a changed role for NGG NTS during an emergency. The *Electricity Market Reform* process could result in changes to NGET's role, notably if a capacity mechanism managed by NGET is implemented.

Question 2: Do respondents consider that the transmission and gas distribution price control periods should remain aligned for future review periods?

There are potential benefits in keeping the transmission and gas distribution price control periods aligned, including optimising the alignment of investments incentives at the NTS/GDN interface. From a workload perspective, Ofgem need to ensure that it can dedicate resources to provide sufficient scrutiny and regulatory oversight to the formulation of both controls. Running the two processes in parallel will also create resource issues in other stakeholder organisations.

CHAPTER 3: Making sure stakeholders' views are heard

Question 1: Do you have any comments of the overall approach to stakeholder engagement?

In general, we welcome the approach and think that the PCRF has an important role in this context in providing some coordination of what may be divergent stakeholder perspectives emerging from stakeholder events. What is not clear at this stage is the extent to which stakeholder views will genuinely influence network companies' business plans and the extent to which conflicting views will be reconciled. It is worth noting that our experience is that the network companies have always been open to bilateral discussions under previous price control arrangements.

Question 2: Do you have any views on how our engagement process and that of the network companies could be made more effective?

Stakeholders are generally unwilling to provide meaningful inputs at large, open events and these events are best used for providing general updates on progress. The reality is that while stakeholders have an interest in the outcome of the price control, it is fundamental to the network companies who will focus significant resources on it and in particular the financing proposals.

For users of the networks, it is the commercial framework, incentives on the network businesses and level and stability of network charges that are important. It is in commenting on proposals in these areas that effective stakeholder engagement will be seen.

Ofgem must also recognise that there is a significant information asymmetry between the network companies and other stakeholders. Our ability to provide constructive input into the process will be constrained by limited access to detailed information, some of which might be deemed confidential.

CHAPTER 4: Determining and incentivising output delivery

Question 1: Do you consider the proposed outputs and associated incentives, along with the other elements of the proposals, will ensure companies deliver value-for-money for consumers and play their role in delivering a sustainable energy sector?

The RIIO model represents a major shift in how price controls have been set, with a focus on defining high-level outputs rather than detailed inputs. We agree that there is uncertainty about what investment needs to be undertaken and by when and that the scale of the investment is significant. Whether the RIIO framework will network companies to deliver what consumers value is unclear at this time, as the key element in networks' decision making process would seem still to be their confidence that any investments will be remunerated over the asset life.

Also, the determination of "value for money" for consumers is difficult and perception of whether this objective has been met will change over the course of the extended price control period and beyond for outputs that span more than one control. The RIIO framework is also more complex than RPI-X, with a range of primary and secondary outputs and associated incentives and uncertainty mechanisms. Industry scrutiny will not be straightforward and all stakeholders will rely on Ofgem's regulatory oversight.

Question 2: Do you consider that the proposed outputs and incentive arrangements are proportionate?

Historically, network companies have invested conservatively with minimal risk to investments being disallowed. This behaviour was in line with incentives on them to invest where there was a demonstrable user commitment. This approach provided a level of certainty for the network companies, Ofgem and stakeholders. The RIIO framework has, in part, been established to facilitate anticipatory investments. This will require a compelling needs case to be demonstrated, together with precisely defined secondary deliverables to mitigate the risk of asset stranding. Our view remains that rather than undertake wholly anticipatory investment, the case for which may be poorly defined, this investment must be guided, at least in part, by user commitment. This will minimise stranding risk as assets will be constructed where users who are willing to commit, require them and ensure that scarce resources are correctly deployed. To the extent that anticipatory investments are permitted, there needs to be an appropriate balance between risk and reward faced by the networks and consumers.

Question 3: Do you have any views on the proposed outputs or incentive mechanisms?

We agree that the outputs for gas and electricity transmission can be different where this reflects differences between each network and that it is appropriate not to define outputs for "Social Obligations" for the transmission companies.

Connections in both gas and electricity should be incentivised and we believe that the gas connections need to be reviewed both in terms of codifying the process and the interaction with planning;

Reliability and Availability: The electricity primary outputs and secondary deliverables appear to be appropriate. In gas, the proposal appears to be that existing arrangements would continue to apply. We would like Ofgem to confirm that these arrangements will be subject to review and in particular the entry capacity incentive framework;

Environmental Impact: The proposed outputs are appropriate;

Customer Satisfaction: We agree that a customer performance metric is appropriate, but do not support the introduction of discretionary rewards for effective stakeholder engagement;

We also agree that there should be consideration of alignment between the SO and TO activities. Although this has been raised in the context of optimising constraint costs arising from electricity TO activities, it is equally relevant to the gas SO and TO and in particular the linkage between the capacity release mechanisms managed by the SO and capacity provision undertaken by the TO.

CHAPTER 5: Assessing efficient costs

Question 1: Is our proposed approach to cost assessment appropriate?

Moving away from approving individual projects or assets and agreeing to a set of high-level outputs and secondary deliverables together with extending the term of the price control makes arguably makes determining efficient costs more difficult and uncertain. With a more tenuous linkage between inputs and outputs, we would expect Ofgem's cost assessments to be extremely rigorous, rather than light-handed. This is particularly true for RIIO-T1 assessment as limited historic benchmarking or comparator information will be available.

Question 2: Do you have any views on our proposed process for proportionate treatment?

We are not convinced that any network company will be in a position to be fast-tracked. Our concern is that at the time the decision on fast-tracking is due to be taken, it will be ten years out from the end of a new eight year price control. We question whether any network company will have developed a meaningful business plan that is robust and can deliver the RIIO objectives. Inappropriate fast-tracking will increase risks to consumers. Our preference would be to delay the fast-tracking option until RIIO-T2 and focus the time and resources on undertaking detailed analyses of the business plans to assess the impact on consumers and on helping to deliver broader energy policy objectives.

Question 3: Do you have any views on the criteria for assessing business plans? Are any of the criteria highlighted inappropriate? Should any additional criteria be added?

We agree that a mix of cost assessment criteria and metrics is appropriate. Although a "totex" approach is consistent with symmetrical incentives on capex and opex, we agree that Ofgem should use a disaggregated assessment as a sense check. In our view, part of the RIIO-T1 assessment process should be about establishing a framework that will provide benchmarking data for use in future RIIO settlements.

Question 4: Do you have any views on the proposed role for competition in third party delivery?

Our current view is that we are yet to be convinced that third parties are necessarily better placed than network businesses operating under financial incentives and licence obligations to deliver network assets.

CHAPTER 6: Managing uncertainty

Question 1: Do you have any views on the uncertainty mechanisms identified?

We agree that it should be the network companies that manage uncertainty and that the regulatory framework should not be designed as a safety net against all forms of uncertainty. Managing uncertainty must be a key part of the regulatory "contract" and network companies must factor uncertainty into defining their outputs and deliverables and the associated funding required. However, we do recognise that there is uncertainty with the investment required to meet climate change and renewable energy targets and that some mechanisms to mitigate these uncertainties are appropriate.

Introducing a range of uncertainty mechanism increases complexity and makes it difficult to understand the impact on revenues and network charges. We have long argued the case for predictable transportation costs. Introduction of uncertainty mechanisms together with incentives on a range of primary outputs and secondary deliverables is likely to introduce more volatility and will make transportation costs much more variable and harder to forecast.

Question 2: Are there any additional uncertainty mechanisms required that we have not identified?

We have not identified any addition uncertainty mechanisms.

Question 3: Are there any mechanisms that we have included that are not necessary and, if so, why?

We are not convinced that extending price controls to eight-years will deliver the benefits that Ofgem claim. The inclusion of a mid-period (four year) review arguably dilutes the incentive to take a longer-term planning perspective and de-risks any decisions taken.

CHAPTER 7: Innovation

Question 1: Do you have any views on the role of innovation in RIIO-TI?

As the whole focus of the RIIO framework is to drive innovative solutions, we question whether an additional innovation stimulus is required. This represents an additional cost to consumers and, if a proposed innovation cannot meet the "value for money" criteria in Ofgem's cost assessment it is unclear why it should receive funding.

Question 2: Do you have any views on the time limited innovation stimulus?

We do not agree that a strong case has been made to implement an innovation stimulus for transmission companies. As noted in our answer to question 1 above, where any innovation can demonstrably deliver long-term benefits, it should be funded under the main price control arrangements. This should provide sufficient incentive for the network companies only to spend money where they think there is a realistic prospect of delivering benefits. Our understanding of the RIIO framework is that outputs and secondary deliverables may be defined to span price control periods where this is demonstrated to deliver value in the longer term.

CHAPTER 8: Financing efficient delivery

Ofgem believe that the new regulatory framework will contribute to lower network charges even with the additional investment that is required, largely due to a lower weighted average cost of capital and efficiency savings. While these conclusions are difficult to validate or challenge, equally valid arguments could be made that extending the price control period increases the risk and uncertainty for network companies and, when considered against a background of capital scarcity, an increased cost of capital might be required. Also, replacement of the explicit efficiency incentives of five year RPI-X, with a framework designed to allow a more flexible approach over a longer period may reduce efficiency. It is difficult to take a firm view of the likely outcomes at this stage.