

Jonathan Brearley,
Ofgem,
9 Millbank,
London,
SW1P 3GE

4th September 2017

Sent via email to: riio2@ofgem.gov.uk

Dear Jonathon,

RE: RIIO-2 Framework Open Letter

Energy UK is the trade association for the energy industry. We represent over 90 members made up of generators and gas and electricity suppliers of all kinds and sizes as well as other businesses operating in the energy industry. Together our members generate more than 90 per cent of the UK's total electricity output, supplying more than 26 million homes and investing more than £11 billion in the British economy in 2012.

Energy UK strongly believes in promoting competitive energy markets that produce good outcomes for consumers. In this context, we are committed to working with Government, regulators, consumer groups and our members to develop Personal Projection methodologies which enhance consumer trust and effective engagement. At the same time, Energy UK believes in a stable and predictable regulatory regime that fosters innovation, market entry and growth, bringing benefits to consumers and helping provide the certainty that is needed to encourage investment and enhance the competitiveness of the UK economy.

Energy UK held a call to discuss initial views with members, discussed RIIO – 2 Framework across a number of committees at Energy UK including the Regulation Managers Group under the retail directorate, the Flexibility WG under the New Energy Services and Heat Directorate, and the Electricity Codes Sub-Committee under the Generation directorate. This is Energy UK's response to Ofgem's open letter on the RIIO-2 framework. We would be happy to discuss any of the points made in further detail with Ofgem or any other interested party if this is considered to be beneficial.

Executive Summary

Energy UK welcomes Ofgem's open letter, and early engagement on the RIIO-2 framework. We look forward to supporting Ofgem through the process. There are a number of key areas arising from the open letter where Energy UK members believe are important to this response, these include:

- ▶ Energy UK is supportive of the RIIO-2 process including greater engagement with consumers, customers and of industry stakeholders. Members of Energy UK have separately called for Ofgem to take a more proactive approach to stakeholder engagement by seeking out affected parties and informing them about key issues. Therefore we welcome the early engagement with the RIIO – 2 process.
- ▶ Energy UK members would hope to see, and call for, a comprehensive review of RIIO-1. This will ensure that industry is able to provide comprehensive and useful feedback to Ofgem in the future which will lead to better outcomes for all parties.
- ▶ Energy UK would like to see longer notification periods for changes so suppliers' tariffs reflect actual cost.
- ▶ Energy UK would like a clearer vision of decarbonising heat because this could make a difference to how Energy UK members respond to RIIO – 2 in the future.
- ▶ Energy UK is supportive of innovation across Distribution Network Operators (DNOs) and industry in order that we better use our current assets. So far as electricity networks are concerned, Energy UK would rather see existing assets be used in a smarter, more effective way than more assets built and risk them being stranded.

Energy UK Response

The Overarching Objective

Energy UK agrees, in principle, with Ofgem's overarching objective in designing RIIO-2 to "ensure regulated network companies deliver the value for money services that consumers want and need." Ultimately, the end consumer should be at the heart of the decision making process, and keeping bills low for customers. That being said, we have seen that Citizen's Advice produced a report that presents a consumer view of DNO business plans which is good evidence of there being alternative voices within the industry of RIIO and Energy UK believes Ofgem should consider this going forward¹.

Giving consumers a stronger voice in setting outputs, shaping and assessing business plans

Targeted, timely and effective stakeholder engagement will be important to the success of RIIO-2. Energy UK believes that the stakeholder engagement proposal that Ofgem has outlined is proportionate. Particularly, the Water consumer Forum has had positive responses by stakeholders who have taken part in the past. Our members agree that consumers and customers should have a stronger voice given that nearly 30 per cent of the customer energy bill represents network costs. At the same time, we understand that this is complex regulation and therefore we would like to see an effort from DNOs to educate stakeholders of the impacts of RIIO in a clear and informative way. This additional educational engagement with stakeholders should not affect RIIO-2's delivery timeline however which is why we are happy to see early engagement from Ofgem.

Having said that, Energy UK does not feel there is enough information available to respond meaningfully on RIIO-1's outputs, their appropriateness, whether they incentivised the right behaviours or, whether their framework can be improved. Energy UK believes there needs to be a comprehensive review of RIIO-1, in conjunction with stakeholders, so that industry and consumer representatives can constructively contribute to this debate.

Allowing regulated companies to earn returns that are fair and represent good value for consumers, properly reflecting the risks faced in these businesses and prevailing financial market conditions

Energy UK believes that Ofgem needs to change the RIIO framework to facilitate returns that result in lower costs for consumers. Suppliers contract with consumers on a one, two and three year basis. Many of these contracts will be 'fixed price' where the network charge is incorporated into the overall unit rate and fixed charges. Suppliers' ability to forecast network tariffs accurately over that time is the key to ensuring that the consumer price is most reflective of network costs.

RIIO-2 is a 'cliff edge' for suppliers, and also for network users (generators, pass through demand users) who ultimately pay the charges. Not knowing whether network operator allowed revenues will go up or down at the beginning of the new price control period is a risk for suppliers. If Ofgem announce the allowed revenues late in the process it will cause issues for suppliers. It will make forecasting the network charges for customer pricing very difficult. This uncertainty may result in the need for suppliers to increase risk premiums in customer contracts to cover the risk on these costs. This is not something Energy UK wishes to see happen.

Lack of allowed revenue certainty can also cause inappropriate market price diversion. Those who price low will gain customers but lose money and those who price high will lose customers. Regulated charges, by their very nature, should not cause this impact and uncertainty in the competitive market nor should they provide such a risk to areas of the supply market. Smaller supplier are particularly at risk as they may not have the resource or expertise to understand that such risks are present, potentially resulting in financial losses. Generators will need to also know the outcomes of any re-zoning activity early on. This could significantly affect their tariffs, and therefore their economics.

Ofgem should consider how we ensure there is a smooth transition from RIIO-1 to RIIO-2. Towards the end of RIIO-ED1 Ofgem employed an approach of fixing the revenues for the first year and then

¹ Energy Consumers' Missing Billions - <https://www.citizensadvice.org.uk/cymraeg/about-us/policy/policy-research-topics/energy-policy-research-and-consultation-responses/energy-policy-research/energy-consumers-missing-billions/>

adjusting it for future years of the price control once revenues are known. We would encourage Ofgem to use a similar approach during this control, giving at least 15 months' notice, of Allowed Revenues in order to fit in with DUoS tariff publication timescales.

Energy UK generally supports synergy between electricity transmission and distribution; Energy UK consistently promotes a whole systems approach. However we are concerned about uncertainty. Attempting to align both price controls at the same time means that industry will be speculating about both price controls, rather than having some certainty in one. It also results in concentrated workload for Ofgem, National Grid and all Market Participants. If Ofgem could overcome these concerns then Energy UK would support further looking at aligning price controls.

Energy UK asks that the RIIO-2 price control period accurately reflect the weighted average cost of capital for regulated networks in order to provide value to consumers. As investors increasingly turn to regulated assets as a hedge against financial market volatility, the price control should consider the increased liquidity seen in the debt market, and the impact this is having on the cost of capital.

Incentivising companies to drive consumer value by shaping or proactively responding to changes in how networks are used and services are delivered.

While Energy UK supports that longer term incentives will incentivise networks to make longer term investments to deliver overall system improvements, we also acknowledge that it is likely that there will be variables that change the system considerably during an eight year period. This could result in the price control being out of sync with the network system's environment. Therefore, we consider it is vitally important that mechanisms to support flexibility within the price control structure need to be taken forward. We note that in the current price control period there have been a number of adjustments to both electricity and gas revenues to take account of changes not envisaged when the price control was set.

Energy UK does not think there is enough information available to comment on the detail of business plans, and therefore should also be covered in the comprehensive RIIO-1 review we have requested above. In general, business plans should be strongly aligned to the agreed RIIO-2 outputs. The relationship between the outputs and business plan should be clear with a process for review against outputs to ensure objectives met with value for money and the best outcomes for the consumer.

Using the regulatory framework, or competition where appropriate, to drive innovation and efficiency

Innovation is of vital importance to the development of efficient, flexible networks that are required now and more so in the future. The emergence and uptake of low carbon technologies, electrification of transport and decarbonisation of heat will provide significant challenges to the UK's electricity and gas systems and networks should be flexible in responding to these changes to use the most cost efficient solutions. This innovation should in part come from industry, but also by DNOs who should be looking for new solutions to drive costs down to support a more flexible system. Energy UK members believe that while there is an incentive scheme for DNOs to look for innovative solutions, for example in the past, the Low Carbon Network Fund (LCNF), that networks should be sharing this information in a standardised way, and should be aiming to scale these projects. It is also important that innovation projects consider implementation pathways and customer impacts at an early stage.

Evaluating existing competitive models in order to benefit RIIO-2 will require critical evaluation of those competitive regimes to assess their strengths and where they could be improved. It is important to recognise that competition-driven regimes should not compromise the long-term value for money for the consumer. Whilst driving down prices quickly is positive for the consumer in the short term, a network designed for longevity and allowing for innovation might not be at the cheapest capital cost. That does not necessarily correlate that it is not the best value for the consumer over the course of a number of price controls.

It is important that Ofgem works with BEIS, the networks, and wider energy stakeholders to ensure that the RIIO-2 Framework reflects a shared vision with other innovation mechanisms complementing the innovation stimulus to support technology development across the whole value chain.

Simplifying the price controls by focusing on items of greatest value to consumers

Energy UK and its members are firmly of the opinion that the Electricity System Operator and National Grid Transmission Owner (TO) should have a separate incentive scheme due to potential conflicts of interest. It does not make sense that there is a joint incentive scheme for the TO and SO, however, Ofgem should consider how independent incentive schemes would interact; it is not in the consumer's best interest to create incentives schemes that are competing or conflicting. This includes incentives on the gas side of business as well as across electricity distribution, system operator and transmission.

Energy UK will continue to feed into the RIIO 2 project, and welcome follow-up conversations and meetings on these topics. If you would like to discuss the above or any other related matters, please contact me directly on 0207 747 2931 or at cathal.mcsweeney@energy-uk.org.uk, or my colleague Kate Dooley on 02077472942 or at kate.dooley@energy-uk.org.uk.

Regards,

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