

2 February 2018

Steve McMahon
Ofgem
Commonwealth House
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Albion Street
Glasgow
G1 1LH

Dear Steve,

Consultation on a Potential RIIO-ED1 Mid-Period Review

The Energy Networks Association (ENA) welcomes the opportunity to respond to this consultation in which Ofgem seek views on issues that should be considered as part of a Mid-Period Review (MPR), as currently defined, and on potential extensions of the scope of the MPR.

This response sets out a number of concerns raised by our electricity and gas members about the consultation document and in particular options that could extend the scope of a review should one be initiated.

About ENA and our members

ENA represents the “wires and pipes” transmission and distribution network operators for gas and electricity in the UK and Ireland. Our members control and maintain the critical national infrastructure that delivers these vital services into customers’ homes and businesses.

General Concerns

Our members recognise and support the inclusion of a Mid-Period Review (MPR) mechanism as set out within the current eight year price control and the optionality it provides as a way to manage unforeseen changes in government policy and their impacts and/or any emerging need for new outputs. The scope was documented very clearly in Ofgem’s RIIO-ED1 strategy decision documentation, in which Ofgem also made statements that ruled out any broadening of that scope, and it was in that context that price controls are accepted by regulated businesses. Our members would therefore have serious concerns about any broadening of the scope of an MPR for ED-1, as it would result in significant negative impacts for consumers. Below we outline these concerns in more detail.

Regulatory certainty

A stable and predictable regulatory regime is fundamental to investor confidence and their perceptions of the GB regulated energy sector as a place to invest. Regulatory certainty is central to investors’ willingness to invest, the conditions for that investment and the country’s ability to attract the capital investment needed in our networks over the course of the current price controls and beyond. Arguably, current political circumstances make this more important than ever, especially as Ofgem forecasts suggest that around £19bn of new investment will be needed over the remainder of the current electricity distribution price control in addition to the £6.6bn that has already been invested in electricity distribution

networks since 2015. Investment in transmission and gas networks will add significantly to these figures.

Ofgem recognise and share our concerns about the impacts of introducing the type of regulatory uncertainty that would come about from an increase in scope of the MPR. These are set out in the draft Impact Assessment¹ accompanying this MPR consultation, which identifies a number of the risks associated with extending the MPR's scope including:

- Negative impact on regulatory confidence, including future finance costs;
- Impact on investment (with investment less likely to go ahead);
- Reduced drive to deliver efficiencies that are in the consumer interest.

Recognition of these risks are further reflected in Ofgem's decision² on the recent MPR for gas & electricity transmission and gas distribution;

"We are therefore conscious of the need to balance the reduction of costs to consumers in the short term with the introduction of regulatory risk and uncertainty, which could ultimately lead to high costs for consumers. Based on this, we consider that the benefits of maintaining regulatory confidence and ensuring companies focus on the long term outweigh the potential short term benefits of widening the scope of the MPR".

Further the decision went on to say:

"We believe that widening the scope of the MPR in this way would have detrimental effects on consumers. The move to an eight-year price control under RIIO is driven by a desire to encourage the companies to adopt longer term strategies and innovate in order to deliver long term savings to consumers. It would be inconsistent to reopen the price control more widely as it would undermine the benefits of the eight-year price control and also damage regulatory confidence. Any damage to regulatory confidence would increase the cost of finance, which would increase consumers' bills in the future. For example, a 10 to 50 basis point increase in the cost of capital across the three RIIO sectors for an eight-year regulatory period could increase costs to consumers by £390m to £1.9bn. We think this impact would outweigh any short-term gains to consumers by clawing back money from areas beyond our proposed scope."

Ofgem's committed regulatory approach

Consistent with this recognition of the need for regulatory certainty Ofgem's Strategy Decision for the RIIO-ED1 electricity distribution price control³ (uncertainty mechanisms) sets a clear framework and commitment to any future MPR under ED-1. Specifically the Strategy Decision committed to;

"Recognising the scope for significant changes in outputs during an eight-year price control period, the RIIO framework sets out a provision for a mid-period review of output requirements. In setting a mid-period review there is a risk that it could undermine the purpose of setting a longer price control period. Consequently, we propose to restrict the scope for the mid-period review to changes to outputs that can be justified by clear changes in government policy and the introduction of new outputs that are needed to meet the needs of consumers and other network users."

¹ https://www.ofgem.gov.uk/system/files/docs/2017/11/ed_mpr_consultation.pdf

² Ofgem, "Decision on a mid-period review for RIIO-T1 and GD1", 12 May 2016, Available at: https://www.ofgem.gov.uk/system/files/docs/2016/05/mpr_decision_document_final.pdf

³ https://www.ofgem.gov.uk/sites/default/files/docs/2013/02/riioed1decuncertaintymechanisms_0.pdf

“The scope of the mid-period review of output requirements will be restricted to cover: material changes to existing outputs that can be justified by clear changes in government policy (e.g. if government policy on climate change changes, a higher or lower level of delivery or performance may be needed) introducing new outputs that may be needed to meet the needs of consumers and other network users.

Other than in these circumstances, the mid-period review will not be used to adjust the output measures or output incentives that were set at the price control review.

The mid-period review process will not be used to consider revenue adjustments that could be triggered throughout the process by other mechanisms. Should the outcome of the mid-period review be a change to an existing output, we will not apply any alterations retrospectively (e.g. a change in the incentive rate or to the output level).”

Further the decision went on to say;

“The mid-period review is intended to cover external factors affecting the operation of the RIIO-ED1 price control. It is not intended to be an opportunity for either Ofgem or the DNOs to conduct a mini price review. As such we are keeping the scope of the mid-period review tight. The submission of business plans is the key opportunity for DNOs to propose the outputs they believe are required for RIIO-ED1. Stakeholders should provide their views on the DNOs plans and our proposals for each DNO at the appropriate stages of the review. The mid-period review should not be seen as an opportunity to re-open decisions taken at the price control.”

Regulatory and legal precedent

We are also mindful of and agree with the arguments put forward by Ofgem in defence of an appeal by British Gas Trading Ltd (BGT) against the RIIO-1 Strategy Decision, including the question of appropriate design of financial incentive and setting of targets. The Competition and Markets Authority (CMA) decision⁴ supported Ofgem’s position and recognised that as set RIIO would ensure that any rewards would need to be justified by substantial improvements in performance.

Any significant extension of scope under the MPR would therefore be wholly inconsistent with Ofgem’s position in response to the BGT appeal, the ruling by the CMA and would effectively constitute a retrospective reopening of the price control with all its negative impacts.

Conclusions

Our members ask that Ofgem consider carefully the points set out here when coming to a decision. We urge Ofgem to continue to recognise that regulatory predictability and stability is essential if we are to ensure consumers’ long term interests are at the heart of the decision making process. The RIIO framework has successfully created the conditions for substantial investment in our energy networks with resultant benefits to end consumers and the wider economy and it is more important now than ever that this is continued.

A stable and predictable regulatory framework is an essential element of an efficient regime that maximises benefits and minimises costs to consumers. Credibility and trust are also vital as is recognition of the legitimate expectations of investors and the avoidance of unnecessary introduction of risk which would raise the cost of capital in future price controls

⁴https://assets.publishing.service.gov.uk/media/5609588440f0b6036a00001f/BGT_final_determination.pdf

and therefore increase consumer bills. Any extension to the scope of the MPR would create significant uncertainty and risk for markets and investors.

Finally we believe that any extension in the scope of an MPR would run counter to the principles of good regulation and may lead to outcomes that are not in the interests of current and future consumers.

If you have any questions on the points raised in this response, please contact John Spurgeon, Head of Regulatory Policy email: john.spurgeon@energynetworks.org

Yours sincerely

A handwritten signature in blue ink that reads 'David Smith'.

David Smith
Chief Executive