

# **RIIO-2 Framework Consultation**

## **Chemical Industries Association Response.**

The Chemical Industries Association (CIA) welcomes the opportunity to comment on Ofgem's approach to setting price controls for GB gas and electricity networks. The CIA is the organisation that represents chemical and pharmaceutical companies located throughout the UK.

### **About our industry**

The UK chemical and pharmaceutical industries have a strong record as manufacturing's number one export earner (on a value-added basis) and a provider of essential inputs to UK value chains. This includes products and technologies which are key enablers of climate change solutions. We therefore have a strong contribution to make both to rebalancing and greening the economy.

However, the chemical industry is energy intensive, competes globally for market share and inward investment, and has already done much to improve the energy efficiency of our existing production assets. Our contribution is therefore critically dependent on secure and competitive energy supplies and carbon reduction schemes which do not leave us internationally exposed. Energy is our number one issue.

### **We strongly support rapid and transitional reform of the RIIO framework and funding arrangements for GB gas and electricity networks.**

Current GB energy market regulation and policy matters are too complex, resulting in our energy cost base being uncompetitive relative to competing nations— more than 50% above the EU median for large energy users.

Key areas of concern include the £100bn cost of support for low carbon power that has been incurred to date, coupled with a rapid escalation in network costs all of which are borne directly by energy consumers.

These costs directly impact domestic affordability and critically our wider economy as the UK's industrial competitiveness, and our ability to compete internationally is eroded. The effects are felt directly and most acutely by Energy Intensive sectors such as ours, as well as the entire supply chains of industries and services whose customers and suppliers depend upon our products.

It is therefore critically important that energy regulation and network funding arrangements are simplified and reformed as a matter of urgency and delivered in a more competitive and cost effective way . There is much greater scope for competitive signals and to allow markets to reveal energy investment needs and efficient levels of costs, rather than try to predict them on a periodic basis.

We believe that the recommendations of Dieter Helm's Cost of Energy Review regarding network costs address many of the challenges facing government and its regulators and are capable of delivering more competitive and secure energy supplies as well as complementing the Carbon reduction aims of the Clean Growth Strategy, and wider Industrial Strategy.

Specifically we agree that:

- ☐ Regulation of networks under the legacy model developed since privatisation has, and will continue to fail consumers given the rapid evolution of our energy landscapes and emergent industry structures constrained by the regulatory model, and
- ☐ In absence of clear and timely long term investment signals, security of supply will be undermined in both our network infrastructure and the range of diverse, secure, sustainable and affordable energy supplies available to us
- ☐ We agree that independent regional and national system operators are best placed to conduct auctions for the provision of energy investment needs and these should be open to all market participants, and be technology neutral.
- ☐ We agree that all future significant investment in our energy systems should ultimately be underpinned by consumers, and that this should be distributed in a fair and proportionate manner that doesn't impact affordability or international industrial competitiveness.

We are concerned that Ofgem's proposed approach to setting price controls for GB gas and electricity networks fails to address many of our concerns and discounts the recommendations made to government by their independent review and panel of experts.

We do however welcome Ofgem's underlying commitment to increase competition, give consumers a stronger voice, simplify and ensure fair returns and funding.

We would urge Ofgem to rapidly develop and communicate a transitional programme of reform to deliver greater competition in, and between geographic network owners as well as third parties, and enable market forces to deliver secure, and affordable energy infrastructure fit for the evolving energy landscape.

**Q1. How can we enhance these models and strengthen the role of stakeholders in providing input and challenge to company plans?**

**We fully support engagement of Customers, Users and stakeholders in assessing, challenging and reporting on business plans.**

**The major challenge is the level of resource, expertise and time commitment necessary to meaningfully engage, understand and evaluate complex plans, risks, opportunities and uncertainties.**

**It is critically important Ofgem provides oversight of the process and works with stakeholders to understand their needs of in terms of information provision and the depth of engagement and analysis necessary to make informed decisions.**

**Ofgem should not under estimate the challenges for individual users or representative organisations in providing the resource and expertise necessary to engage with complex price controls. There are a several key actions that Ofgem can take that better facilitate engagement:**

**To keep the number, structure and composition of any advisory groups simple and manageable**

- To provide oversight of the process, clarity on the timing and level of engagement required from the outset**
- To focus work by providing simple, clear and timely preparatory material to aid consultation by stakeholder representatives and guide discussion**
- To engage with stakeholders to understand what information they require to be able to engage meaningfully and ensure that stakeholder groups have access to succinct, clearly laid out data for them to assess with sufficient time to enable them to do this.**

**➔ What are your views on the proposal to have Open Hearings on areas of contention that have been identified by the groups?**

**We support the use of Open Hearings for areas of contention**

**Q2. Do you agree with our preferred position to set the price control for a five-year period, but with the flexibility to set some allowances over a longer period, if companies can present a compelling justification, such as on innovation or efficiency grounds?**

**No,  
Periodic price control reviews should be reformed to deliver greater scope for competition and for markets to bear down on costs.**

**The Gas and Markets Authority's principle objective includes protecting existing and future consumers by promoting effective competition between persons engaged in, or in commercial activities connected with the transportation of energy.**

**1 The future is fundamentally uncertain, and challenged by fast technical progress.**

**Whether a 5 or 8 year period, looking ahead to 2025 - 2030 is an extraordinarily difficult task, taking us well into the Fifth Carbon Budget, with a period of great technical and behavioural change to our energy landscape.**

**2. Technical developments are undermining the distinction between networks, power generation and gas supply, the demand side, and storage.**

**The need for reinforcement or extension of a network might be better met through investment in local supplies, by storage and, or the demand side. To deliver the optimal economic solution for consumers, all players including third parties should be able compete in providing potential solutions.**

**3. There are lots of opportunities to let markets reveal costs through auction, rather than try to predict them on a periodic basis.**

**→ What type of cost categories should be set over a longer period?**

**We support aligning allowances to specific projects development and delivery timescales. This creates greater certainty for investors and project managers. To optimise risk for consumers this necessitates indexation of actual input prices such as the cost of raw materials, labour and other cost drivers to allowances.**

**We also support aligning longer term allowances for System Operators whose direct costs are fundamentally the management and investment in people and information systems. These can be more readily forecast, benchmarked, reviewed and scaled to other services.**

**→ How could we mitigate the potential disruption this might cause to the rest of the framework?**

**N/A**

**→ What additional measures might be required to support longer-term thinking among network companies?**

**Innovation funding for network companies is a fundamental necessity to understand and mitigate future risks, and maintain research and development that might benefit consumers.**

**→ Do you instead support the option of retaining eight-year price controls with a more extensive Mid-Period Review (MPR)?**

**No**

**→ What impact might the alternative option of an eight-year price control with a more extensive MPR have on how network companies plan and operate their businesses?**

**As above**

***Whole system outcomes***

**Q3. In what ways can the price control framework be an effective enabler or barrier to the delivery of whole system outcomes?**

**→ If there are barriers, how do you think these can be removed?**

**We support an alternative model of regulation whereby new capital investment projects of significant financial value are open to competitive bidding including third parties. We believe awarding such projects through price control regulation in a period of great uncertainty and fundamental change is fundamentally flawed, leading to greater risk for investors and consumers.**

**→ What elements of the price control should we prioritise to enable whole system outcomes?**

**The creation of competition within and between geographic network monopolies and third party players.**

**All activities currently carried out by geographical network owners could be put out to tender inviting third parties to bid for investment, operation and ongoing maintenance.**

**Transmission and Distribution System Operators should determine 'system requirements' to ensure security of supply consistent with the carbon budgets and targets, and auction contracts for the delivery of required investments and services.**

**Q4. Do you agree with our minded-to position to retain the current start dates for the electricity transmission and electricity distribution price controls, and not align them?**

**No, to enable whole system outcomes in a period in which the transmission and distribution landscape is fundamentally changing we believe it is paramount that any form of control or award of investment is aligned.**

**Q5. In defining the term 'whole system', what should we focus on for the RIIO-2 period, and what other areas should we consider in the longer-term?**

**→ Are there any implementation limits to this definition?**

**As above - The creation of competition within and between geographic network monopolies and other potential players.**

#### ***System Operator price control***

**Q6. Do you agree with our view that National Grid's electricity SO price control should be separated from its TO price control?**

**Yes –separation of activities between the entities mandates discrete funding arrangements and incentives.**

**Q7. Do you agree that we should be considering alternative remuneration models for the electricity SO?**

**Yes, this should include both the TSO and DSO. If deferment of an alternative remuneration model is necessary for DSO's there should be a clear transitional path to mitigate the uncertainty and risks this creates for investors and operators.**

**→ If so, do you have any proposals for the types of models we should be considering?**

**We believe a hybrid model could be used. This might include a Regulatory Asset Value (RAV) applicable to large scale IT investment in control systems,**

forecasting and modelling with operational costs remunerated ex ante of service provision based on agreed standards of performance and service.

**Q8. Should we consider alternative remuneration models for the gas SO?**

→ If so, why and what models?

Whilst the extent of change and separation of the gas TO/SO has to date been less, the principles of separating in funding and activities to protect consumers is equally valid.

#### ***Network utilisation, stranding and investment risk***

**Q9. What options, within the price control, should be considered further to help protect consumers against having to pay for costly assets that may not be needed in the future due to changing demand or technology, while ensuring companies meet the reasonable demands for network capacity in a changing energy system?**

In a rapidly changing energy landscape changes in supplies, and demands and network utilisation will create risks of investment stranding or underutilisation. It is critically important that a more holistic and competitive approach to resolving security of supply and network investment is developed and implemented through early reform and greater competition.

Policy proposals being considered under the Electricity Targeted Charging Review may well exacerbate this problem. Charging users for gross power consumption that doesn't fairly reflect their use of the network is likely to undermine the case for new efficient localised generation of decarbonised heat and power. Equally it will incentivise industry clusters to further develop off grid energy islands supplied by private wires. This would increase the overall costs to energy consumers.

#### ***End-use energy efficiency***

**Q10. In light of future challenges such as the decarbonisation of heat, what should be the role of network companies, including SOs, in encouraging a reduction in energy use by consumers in order to reduce future investment in energy networks?**

→ What could the potential scale of this impact be?

Other than demand side response to resolve or reduce investment, the reduction in use of energy by consumers through energy efficiency measures should not be driven or incentivised through an extension of the role of System Operators. It is a matter for policy and market providers to deliver end use energy efficiency.

#### ***Innovation***

**Q11. Do you agree with our proposal to retain dedicated innovation funding, limited to innovation projects which might not otherwise be delivered under the core RIIIO-2 framework?**

Yes –funding targeted specifically at innovation has the potential to deliver benefits for consumers that might not otherwise be researched and developed by network companies.

**Q12. Do you agree with our three broad areas of reform: i) increased alignment of funds to support critical issues associated with the energy transition challenges ii) greater coordination with wider public sector innovation funding and support and iii) increased third party engagement (including potentially exploring direct access to RIIIO innovation funding)?**

Yes

**Q13. What are the key issues we will need to consider in exploring these options for reform at the sector-specific methodology stage, including:**

**(i) What the critical issues may be in each sector and how we can mitigate the bias towards certain types of innovation through focusing on these issues?**

**(ii) How we can better coordinate any dedicated RIIO innovation funding with wider public sector funding and support (including Ofgem initiatives such as the Innovation Link and the Regulatory Sandbox)?**

(iii) How we can enable increased third-party engagement and what could be the potential additional benefits and challenges of providing direct access to third parties in light of the future sources of transformative and disruptive innovation?

Q14. What form could the innovation funding take.

→ What would be the advantages and disadvantages of various approaches?

Q15. How can we further encourage the transition of innovation to BAU in the RII0-2 period? How can we develop our approach to the monitoring and reporting of benefits arising from innovation?

### ***Competition***

Q16. Do you agree with our proposal to extend the role of competition across the sectors (electricity and gas, transmission and distribution)?

**Absolutely yes. We agree with your proposal to apply competition across all network sectors for new, separable and high value projects, and to consider the role of system operators in enabling or implementing such models and facilitate whole system solutions.**

→ What are the trade-offs that will need to be considered in designing the most efficient competitions?

**Timeliness of deliver and the risk to security of supply against the most cost efficient and economic solution.**

Q17. Do you consider there are any reasons why our new, separable and high value criteria might not be applicable across all four sectors?

**No**

→ If so, what alternative criteria might be suitable?

Q18. What could the potential models be for early stage competitions (for design or technical solutions)?

We agree with the models already proposed, with ongoing review and refinement.

→ What are the key challenges in the implementation of such models, and how might we overcome them?

**The rapid establishment of Distribution System Operators, and their separation from asset owner / operators ahead of 2021. These can be overcome by a clear steer and direction and transitional price control arrangements for projects necessitated in the short term.**

### ***Our approach to setting outputs***

Q19. What views do you have on our proposed approach to specifying outputs and setting incentives?

**We support a move toward company specific output deliverables and output delivery incentives.**

→ When might relative or absolute targets for output delivery incentives be appropriate?

→ What impact would automatically resetting targets for output delivery incentives during a price control have? Which outputs might best suit this approach?

### ***Our approach to setting cost allowances***



**Q20. What views do you have on our general approach to setting cost allowances?**

**We support a move toward more use of uncertainty mechanisms, volume drivers and market measures of the costs of inputs. This provides a better balance of risk between investors and consumers.**

**Q21. What views do you have on our intention to index RPEs?**

**We support the use of RPE's rather than set an upfront allowance**

**Q22. What impact would resetting cost allowances based on actual cost performance (eg benchmarked to the average, upper quartile or best performer) during a price control have? Which cost categories might best suit this approach?**

**We support resetting cost allowances based on actual unit cost performance in a sector. This would ensure poor performing networks and their investors are sufficiently incentivised to collaborate and improve performance for the benefit of consumers.**

### **Information-revealing devices**

**Q23. Do you agree with our assessment of IQI?**

**Yes**

**Q24. Do you agree with our assessment of fast-tracking?**

**Yes**

**Q25. What are your views on the options we have described?**

→ **How might these apply in the different sectors?**

→ **Should we retain the IQI, amend it or replace it entirely?**

**Amend it to ensure an incentive remains to develop timely and efficient business plans.**

**Q26. What factors should we take into account when assessing plans for example, under fast-tracking (option 2) or a single business plan incentive (option 3)?**

**Q27. Do you have any views on the factors we should take into account when deciding how to differentiate efficiency incentives for companies if we do not use the IQI?**

**Q28. Is an explicit upfront financial reward required to incentivise companies to submit high quality business plans, in addition to differential incentive rates or sharing factors?**

**Q29. Do you have any views on our proposal to remove fast-tracking for transmission?**

**Q30. Do you have any views on how we propose to incentivise better business plans from transmission companies, including removing the prospect of an upfront financial or procedural reward and placing greater reliance on user and consumer engagement and scrutiny?**

### **Annual reports/reporting**

**Q31. How can we best improve the suite of annual reporting requirements to be as efficient and useful as possible?**

**We agreed that annual reports should highlight overall network performance in a clear and accessible way, and critically show the emerging trends over time in underlying costs, efficiency and the benefits and risks to consumers.**

**Q32. How can we make the annual reports easier for stakeholders to understand and more meaningful to use?**

**By providing clear benchmark indicators of financial performance, costs, overarching benefits and savings for consumers.**

#### ***Cost of debt***

**Q33. What are your views on the policy objectives that we have defined with respect to the cost of debt?**

**We agree with the principles that**

- **Consumers should pay no more than an efficient cost of debt.**
- **The cost of debt allowance should reflect the actual cost of debt likely to be incurred by a notionally geared efficient company**
- **The calculation should be simple and transparent.**

**Q34. Which option might help to ensure that the approach to updating the cost of debt methodology delivers best value to consumers and why?**

***Insufficient information to comment***

#### ***Cost of equity***

**Q35. Do you agree with our proposed methodology to estimate the cost of equity?**

**We agree with the proposed methodology to estimate and index the cost of equity.**

**Q36. Do you agree it would be desirable to index the cost of equity?**

**Yes**

**→ Do you have views on our proposal for indexation?**

#### ***Financeability***

**Q37. Do you consider there is merit in removing the indexation of the RAV and adopting a nominal return model in RIIO-2?**

**No – given the significant change to the regulatory funding framework and impacts on investors looking for inflation linked liabilities**

**→ What would be the benefits and drawbacks?**

**Q38. Should the onus for ensuring financeability lie with the network operating companies in whole, or in part?**

**In part**

**Q39. Do you consider the introduction of a revenue floor, to protect the ability of companies to service debt, to have merit?**

**Yes**

#### ***Corporation tax***

**Q40. Do you agree that Ofgem should review the causes of any variances between tax allowances and taxes actually paid to HMRC (including the treatment of group tax relief)?**

**Yes**

**→ Which of the options described in this consultation may be worth investigating further to address any material variances?**

**Option B – Actual payments to HMRC**

#### ***Other finance issues***

**Q41. Do you agree that we should move away from RPI for RIIO-2 (including for the indexation of the RAV if retained as a feature)?**

**Yes**

**→ If yes, which of the two potential indices – CPI or CPIH – might be most suitable?**

➔ Is a phased transition between RPI and the chosen successor index necessary or desirable? **desirable**

Q42. In the light of our proposal not to amend, at a price control framework level, our policies for depreciation and asset lives set in RIIO-1 do you have any views or suggestions that you wish to put forward?

**No**

Q43. We propose to review the fast/slow money split at the business plan submission stage, do you have views that you wish to put forward at this stage?

**No**

Q44. Do you think existing mechanisms for providing allowed revenue to compensate for the raising of notional equity are appropriate in principle and in practice?

#### ***Ensuring fair returns***

Q45. What are your views on each of the options to ensure fair returns we have described in this consultation?

**Fairer returns can be better achieved by enabling greater competition and third party delivery of network services. This coupled with more extensive indexing of the cost of financing businesses, their inputs and the actual delivery of outputs is likely to achieve better results than intervention which creates and distorts incentives.**

Q46. Is RoRE a suitable metric to base return adjustments on?

➔ Are there other metrics that we should consider, and if so why?

**See above**

Q47. Do you have any views on the interlinkages and interactions outlined in this consultation and those that we will need to consider as we develop our sector-specific proposals?

**Yes. Ofgem's proposal to apply competition across network sectors and to consider the role of system operators in enabling or implementing such models and facilitate whole system solutions warrants greater clarity and direction as this sets the materiality and scope of services and revenues that will form under the regulated price control framework.**

Q48. Do you have any views on the issues highlighted that we will consider as we develop our sector-specific proposals?

Q49. Are there any sector-specific issues or policy areas that we should ensure we review and consider as we develop our sector-specific proposals?

Q50. Do you have any views on our high-level proposals for timing of RIIO-2 implementation, and on our proposals for engagement going forward?