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Ørsted's response to the RIIO-2 framework consultation

2 May 2018

Our ref. ANDMH/RIIO2

The Ørsted vision is a world that runs entirely on green energy. In the UK, we develop, construct and operate offshore wind farms and innovative waste-to-energy solutions. We also offer flexibility solutions to our industrial and commercial customers as well as supplying them with electricity and gas. Headquartered in Denmark, Ørsted employs 5,600 people, including over 900 in the UK. Ørsted is the largest offshore wind farm developer, generator and owner in the UK.

We welcome the opportunity to respond to the Ofgem RIIO-2 framework consultation. We view 2021-2026 period covered by the price control as a transformative period for the UK energy system and wish to set out our views on what networks will need to deliver during this time frame.

Implementation of a flexible grid that is fit for the energy transition

Meeting the next series of carbon budgets as set out under the Climate Change Act will require further decarbonisation of power generation, as well as the decarbonisation of the transport and heating sector. These sectors are expected to emphasise electrification as a key solution, which in turn will affect how networks are used.

As a result, end users will be changing their energy consumption patterns as they increasingly take on electric vehicles and seek to leverage the smart metering to optimise their energy usage. The network will need to be flexible to account for this consumption change whilst continuing to support decarbonisation and the variable generation characteristics of renewable energy that now grows at both transmission and distribution levels.

Reflecting this challenge, Ofgem and the Government have set out their ambition for flexibility under the Smart Systems and Flexibility Plan. The need for flexibility within the energy system is further emphasised by the Government in the Clean Growth Strategy. Ofgem can achieve these policy goals by using the price control as one mechanism for progressive change.

Further opening of the provision of services to support the energy transition

As part of the transition, the diversification of the UK power generation portfolio will mean that procurement of ancillary services that support system operation will need to change. Ørsted believes that the traditional procurement of these services from thermal generation technologies will become unviable, but that there is scope for the renewable energy fleet alongside new technologies to provide existing and new services.

A price control can serve as a catalyst to incentivise network companies to efficiently procure services such as frequency response from existing connected green assets, supplemented by new technology and service providers that can enhance system flexibility. These new technologies and service providers have the potential to innovate and deliver solutions in a cost-efficient manner as long as network companies are motivated to facilitate an open and fair market for these products. This market will be important to the SO, but also to DNOs as they transform their companies to take on a DSO role.

Value to the consumer and network customer

In line with standard business practice, any regulated monopoly must also deliver objectives at best value to the consumer. Delivery of these changes should not come at high cost to the consumer. Business processes should be guided by clear principles that foster efficient procurement and expedition of solutions that boost network capabilities. Sound and transparent decision making will help stakeholders assess whether the system is indeed optimised and representative of a low cost, high value network.

Confidence in this process at the network level will in turn help Ørsted to identify the best strategy for our investments in the UK that delivers value to our customers.

Key principles and outcomes for the price control

We support the ‘core’ principles within the RIIO-2 framework consultation by Ofgem for the price control to develop a stronger consumer voice, to respond to how networks are used, to drive innovation and efficiency, to simplify the price control, and to ensure fair returns and financeability. These principles contain some of the essential drivers to apply the required high level of scrutiny to regulated monopolies that facilitates the necessary outcomes described earlier.

However, we also believe that considering whole system outcomes and extending competition (currently ‘sub-principles’ within the proposed framework) to be equally important in delivering the vision for 2021-2026. As such, we have outlined our thoughts below on all of these principles.

Whole system outcomes that respond to how the network is being used

Responding to how energy generation and consumption will change in the future is a key challenge for the energy industry at large. On climate, owners of power generation have responded, and will continue to respond to the shared decarbonisation challenge. BEIS figures indicate that electricity generation from renewable sources doubled from

2012-2016, and now represents 26% of total UK electricity generation[1]. More recently, the UK recorded three days of power generation in 2018 without coal[2]. This reflects the speed and urgency of the power generation response to climate action.

However, electricity networks are yet to respond to the challenge in a manner which reflects this pace of change. Ørsted believes that a flexible grid that is fit for renewables and end-users to be essential for delivering a low-carbon energy system that allows renewable energy to provide system services and for users to fully access emerging green technologies such as electric vehicles and take advantage of smart metering.

For RIIO-2, considering a whole system view that incorporates the vast changes to the energy system should be as much of a pre-requisite as maintaining system integrity.

Extending competition

A whole system transformation will need to be supported by open, transparent and fair markets. We note that in this consultation, Ofgem has emphasised proposals to extend competition for build out of new assets, but has reserved mention of increasing competition in procurement of ancillary services until the RIIO-ED2 sector methodology. We feel this is a lost opportunity to engage in a wider coordination effort between transmission and distribution levels.

Ørsted believes that a well-functioning energy system that delivers at lowest cost to the consumer must have a healthy range of market participants and competitive procurement mechanisms.

Tied to network companies making a fair return however, competition must facilitate the delivery of solutions. Network companies have incentive to ask for more than necessary without delivering outcomes, which requires a strong framework tying their outputs to customer needs. The current situation has led to the network constraints at the distribution level that we see today, creating a bottleneck that risks delaying decarbonisation objectives.

Giving consumers a stronger voice

We support the opportunity for stakeholders to apply a high level of scrutiny within the RIIO-2 framework that should come with the creation of the Customer Engagement, User, and Challenge Groups at their respective levels.

We hope the Customer Engagement and User Groups will be given the right support and analysis from Ofgem as well as the appropriate remit to address critical concerns that allows network companies to respond to stakeholder feedback. The Challenge Group's remit to focus on sustainability, affordability, and protection of vulnerable consumers is also a key back-stop to ensure all interests are represented.

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[1] BEIS DUKES 2016
[2] BBC News, 24 April 2018 – Britain powers on without coal for three days

The success of these stakeholder groups' ability to scrutinise will also be tied to Ofgem and network companies presenting a clear vision on business-as-usual metrics, defining what constitutes outperformance, and how this should be rewarded. Tied to ensuring a fair return for network companies, a failure in the stakeholder engagement process risks increasing costs, not just to domestic consumers, but to industrial and commercial end users and other large energy consumers that face significant use of system costs.

Driving innovation and efficiency

There is a need for innovative solutions and services to be continuously provided that will drive efficient network growth to provide for a smart, flexible whole system outcome. We see various actions taken by the energy industry to support this, such as work within the Electricity Networks Association (ENA) Open Networks project and our own exploration of storage and fast frequency response testing at our Burbo Bank offshore wind farm.

Tied to our views on further opening of the provision of services to support the energy transition, if these solutions can be accessed and deployed via an open and transparent market with a level playing field, then the outcome should increase overall competition that delivers the flexible grid at lowest cost.

We agree with Ofgem's proposal that new innovations will need to be adopted and become business-as-usual. There will also be the need to delineate between operational optimisation that constitute business-as-usual activities (that therefore warrant no outperformance incentive), and genuine innovation that addresses system failures.

Simplifying the price controls

We appreciate that this stage of the RIIO-2 consultation process is targeted at the framework level. In order to address questions around relative to absolute targeting, target resetting etc, we would prefer to see more details of targets set within specific indicators.

Our view is that a clear, defined definition for what constitutes Business-As-Usual behaviour (that therefore accrues no extra reward) and what constitutes outperformance is the key step to bringing clarity and simplicity to the price control. We look forward to discussing in the later consultations as further details arise.

Fair returns and financeability

Efficient cost of financing is a key outcome to ensure that a company remains in good financial health. The right mechanism needs to be established to ensure that the network companies are not unduly influenced in making decisions around debt issuance that are counter-intuitive to market actions. At the same time, high scrutiny must still exist which accurately reflects the lowered risk that a regulated monopoly faces that needs to then produce the correlating lower return when compared with a fully free market peer.

The appendix overleaf contains more focused answers to specific questions listed within the framework consultation. Please do not hesitate to contact myself (andmh@orsted.co.uk, 07827-283-123) should you have further questions.

Yours sincerely,

Andrew Ho
Regulatory Affairs Advisor
Ørsted

Appendix – Response to consultation questions

This section provides our answers to specific questions given within the framework consultation.

Giving consumers a stronger voice

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

The structuring of these groups and their access to information and analysis will need to be well thought out in order for their remit to be achieved in a compliant manner.

We believe that in order for stakeholder groups to engage effectively, they must be given a strong and clear definition of what Business-As-Usual will look like, what going beyond this will look like, and how this is to be rewarded. We appreciate that at this stage of the consultation that high-level drivers and incentives are being discussed, but we hope that prior to the sector-methodologies consultation being released that more detail is available from Ofgem and their interpretation of the above. Section 2.17 of the Enhanced Stakeholder Engagement Guidance places emphasis on the network company to provide some of this information, but should be balanced with more detailed Ofgem guidance on its expectations for each output category. This should also include giving stakeholders clear analysis on prior performance and on specific points of failure within RIIO-1.

Section 3.18 of the framework consultation for the User Group states that the group would examine expenditure forecasts and make an assessment on whether capital projects put forward have the Group's support. Ofgem will have to account for the natural tension that will exist here between the amount of access to information the User Group may have in order to assess these options fully before inside information is revealed which could compromise members of the User Group who are active customers of the network. We would urge that appropriate steps are taken to ensure compliance with the appropriate regulations on inside information such as REMIT and other competition law.

Furthermore, the Enhanced Stakeholder Engagement Guidance states that the groups will support Ofgem's business plan assessment. In the same regard, Ofgem must also offer its ongoing business plan assessment to the various groups during the consultation process. We see this as either a combination of Ofgem sharing its analysis with these groups, or indeed, any outstanding concerns or observations that Ofgem has made when reviewing business plans.

We should also note that the language of the framework consultation assumes that all stakeholders are familiar with the RIIO price control. Given that formation of stakeholder groups is only a feature of RIIO-2, this will introduce more participants, who are likely not familiar with the price control. In the same way that the Charging Futures Forum has offered plain English summaries of network charging, there should be a similar summary offered for RIIO-2. This will increase assurance that stakeholders can all work with a presumed baseline level of understanding.

Responding to changes in how networks are used and considering whole system outcomes

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?
We agree that a five-year price control should be the default length for the price control, as the shorter time period will allow for increased scope to adapt to the pace of change we are seeing within the energy transition and the expected change in usage of the network.

Whist we appreciate the shorter price control period, some form of targeted mid-period review (MPR) during a five-year period may still deliver value to the consumer. This could take the form of a 'lighter' review of the price control at large, or a targeted review if a performance indicator is not met. Some form of MPR may be useful when considering the first ever separate price control for the ESO and how this may affect the ESO and TO respectively.

There should also be some caution to limit the amount of longer term allowances and creating a complex, multi-track price control. An excessive amount of areas that deviate from the five-year price control will be difficult to scrutinise effectively, and difficult to estimate the true value that network companies will be delivering to users.

Where longer term allowances are required, these should be subject reviews at regular intervals that also consider the entire price control and not just the longer-term allowance. This wider review is required so as to remove any unintended consequences such as long-term use of system deviations that may arise from multi-track arrangements.

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?
We welcome language in section 4.48 of the framework consultation which sets out the intent to articulate further what is meant by the term 'whole system', but should be further interpreted to be results based, and therefore seek to define a 'whole system outcome', which Ofgem has not sought to define in this consultation (the language states to seek views on how the price control can best support whole system outcomes, without defining the outcome).

The whole system outcome that Ørsted seeks is outlined earlier in our views on 2021-2026. Applying this to network price controls, Ørsted would like to see consideration on incentivising actions that can further increase the integration of renewable energy into GB and allowing consumers access to smart energy products.

The decarbonisation of power generation means that system service procurement should also seek to utilise the capabilities of such technology to provide frequency response, reactive power etc. However, the framework of system service provision has proven to be resistant to change at present, and non-existent at the distribution level.

Consumers will also need the grid (particularly distribution) to cope with their changing consumption patterns. The grid should not be a barrier to enabling customers to lower their bills through smart metering and the subsequent shift in load profile. The Government intent to end the sale of petrol and diesel vehicles by 2040 will see a dramatic increase in electric vehicle sales and alternative fuel fleets. The RIIO-2 period running 2021-2026 will therefore represent a critical point in which actions must be made that provide the necessary momentum to accommodate this shift.

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

Yes. We support the separation between Transmission Owner (TO) and System Operator (SO) roles, which we see as essential in order to provide a clear and transparent market. A separate price control will be able to further the independence of the SO, which we see as a further step to make it a more responsive, stakeholder oriented organisation. The separation may also incentivise the SO to explore a wider range of options when it comes to system services (e.g. ancillary services)

We would also like to highlight that a separate SO price control should come with a separate stakeholder engagement group that is not the User Group so as to enable the right stakeholders the opportunity to apply scrutiny to the business plan.

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

We support alternative remuneration models than Regulated Asset Value for the SO given the lack of asset base. We do not have a suggested alternative remuneration model at this time.

Driving innovation, efficiency, competition

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 RIIO-2 framework?

Yes. We believe that RIIO-2 may have the ability to deliver whole-system projects as suggested by a stakeholder in section 5.8.

For example, we believe that innovation that promotes the integration of electric vehicles within the distribution network to be a key first step during the 2021-2026 period towards establishing our whole system outcome. In this regard, the RIIO-2 price control becomes a key vehicle to turn genuine innovations made in this area into business-as-usual.

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 RIIO innovation funding)?

Yes. The first point addresses our desire for the network to respond to the energy transition.

The second point is useful in that greater coordination with other activities such as work inside the ENA Open Networks on the Smart, Flexible Energy Systems plan by BEIS and Ofgem can be potentially closer aligned to delivering shared objectives.

The last point we see as also important in opening up the network for non-network companies to deliver services to the grid. This opening up of the market to competition will ultimately lead to a lower cost to the consumer.

Extending competition

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

Yes. A well-designed market with competitive features is preferable to a monopolised system where network planning and procurement are within the same entity.

Ofgem refers to the OFTO regime as an example of competition working. As a participant within the OFTO process, we think that lessons learnt from the current process need to be taken on board before further roll-out can be taken to onshore assets. Within this kind of competitive regime, there is a further need to consider evolving the framework that distributes risks and incentives appropriately to the network owners and to ensure efficient maintenance of assets.

We also note that throughout the framework consultation, Ofgem have largely focused their consultation questions to extend competition for build out of new, separable, high value assets. With relation to competition in procurement of ancillary services, section 5.33 of the framework consultation states that Ofgem have not focused on DSO roles and flexibility markets at the framework level, instead choosing to focus on this within the sector specific RIIO-ED2 methodology.

We feel this represents a lost opportunity to further progress a whole system view on flexibility by not facilitating a discussion on how the DNO to DSO transition will complement transmission system operation, a conversation which is relevant during the 2021-2026 length of the RIIO-2 price control.

In supporting Ofgem's minded-to decision to have the need for a separate price control for the SO, we believe that Ofgem could have thought about competitive flexibility service interactions between transmission and distribution levels at this current stage of consultation. As DNOs begin to transition to DSOs, it will be important for Ofgem to create harmonisation in the way each DSO will approach system services and their procurement so as to create an open, liquid and transparent that interacts in a cohesive manner with the transmission and neighbouring distribution system operators.

Fair returns and financeability

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

Option A for re-calibration of the RIIO-1 indexation policy could be a logical progression to refining the benchmarking methodology. However, we question why analysis into each of the proposed assumption modifications (section 7.18) has not been performed to bring more scrutiny to the existing method, before being placed for stakeholder consultation.

Providing a cost of debt 'allowance' as proposed in option B may not be efficient given the emphasis on looking at past debt performance to create weightings that inform a future decision. Future decisions around investment are not necessarily tied to historical actions or rates. An incorrect weighting and subsequent misaligned setting of the allowance presents a significant risk to efficient decision making around debt management. In order to support this option, more evidence will need to be provided to indicate that a robust approach is taken to ensure a correct setting of any allowance.

A full pass-through approach as suggested by option C requires a fully efficient approach by the network company, in order for costs to be minimised for the consumer. Section 7.27 suggests a lack of visibility that Ofgem has in looking at financing arrangements of network companies. This means the regulator cannot guarantee that network companies have a fully efficient process. We believe that option C should not be considered for this reason, as well as our further view that a full-pass through approach will remove an explicit incentive to seek low cost of debt.

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

An appropriate risk-return allocation is a key outcome, and particularly important for a regulated monopoly that enjoys protections given by the price control. We support this refreshed outlook that more adequately values the equity beta in the range of 0.3-0.5 as given in section 7.46. This conforms with the realistic view of the relatively lowered risks of holding shares in network companies.