



RIIO 2 Framework Consultation Covering Note

GNE welcomes the opportunity to respond to the Framework Consultation. We would like to take the opportunity to develop some high-level views that are reflected in our more detailed response to the specific questions asked in Appendix 3.

As a new entrant we are committed to offering value for money to our customers. In fact, we have a complete alignment of interests with our customers in the price control. Everybody benefits from a well administered price control with monopoly networks efficiently managed. We share the concerns from Citizens Advice about excess returns (or as could be argued monopoly rents) of the networks in RIIO 1. In fact, we welcome WDP's announcement that they will be returning £77M of the networks funding for customers on their networks.

We would like to highlight some high-level challenges for RIIO 2.

Strategic Challenges: Transmission

Previous price controls have been based on relatively stable but gently increasing demand with cost savings and efficiency the priority. We are now in a position where there are two distinct scenarios for both gas and electricity transmission networks.

For electricity there is a risk that widespread adoption of distributed generation may reduce the utilisation of the transmission system and risk stranding assets. In this scenario the price control should consider rethinking its understanding of efficiency based on volume and cost. Instead the *option value* of having a system to back up distributed or other non-grid connected generation and transport energy might be more appropriate. However, there is an alternative scenario with the widespread uptake of electric vehicles (EV) means that electricity demand replaces oil for transportation. In this case major investment will be necessary to facilitate this transition.

For gas transmission it is more difficult to see a case for major investment except if there is a gas quality issue. It is more likely maintenance of the existing network becomes the central activity of its owners in a context of gently declining demand as for example, the penetration of condensing boilers in the population is complete. This will be more familiar technical challenge for setting a price control. It may be that there is more emphasis on controlling operational expenditure as big investment is unlikely to be forthcoming.

From an SO perspective for both systems, the challenges may become more difficult the cost of administering and procurement is likely to remain stable. This should be familiar scenario for regulators.

Strategic challenges: Distribution

Distribution networks respond to the same challenges as the transmission system. However, since they are likely to experience the full impact of distributed or other non-grid connected network there is likely to be a greater need for investment. It may be the case that widespread EV take up will require the development of a whole new network for charging. In this scenario we see no *a priori* reason why the existing networks would automatically be able to expand without some form of competition. Finally, investment in smart will also require funding but will yield substantial efficiency savings.



For the gas distribution networks, we see no obvious case for major capital projects but instead an emphasis on controlling operational expenditure and maintenance. This substantially changes the emphasis of the price control for gas compared to electricity.

Challenges: Economic analysis

From our assessment of the strategic price control issues above, we argue that Ofgem will have to consider a new set of challenges that were not dominant issues in previous reviews:

1. *Option value*: We have already stated that within the price control there are new challenges for the networks that require different emphasis in the way the price control is administered. What becomes important to transmission assets may well be an *option value* of transmission services for those distribution networks regularly in surplus exporting to the grid due to its connected distributed generation. This will be difficult for consumers to accept if the assets are used infrequently.
2. *Fixed cost overhang*: Network costs are overall more fixed than variable. In this case it may appear that for the same spending on fixed cost is providing a reduced utilisation of asset and in the conventional definition inefficient. We would suggest Ofgem responds to this challenge to conventional concepts of efficiency.
3. *Problem of valuation*: We note that the value of the same energy is substantially different for the networks than the supplier, generator and consumer who use the commodity price. It follows that services to the network are likely to be lower in general when compared with commodity value that consumers use. The price control must consider valuation issue if networks are offering services to consumers against other unregulated businesses in competitive markets.

Conclusion

We broadly welcome Ofgem's proposals, especially the greater inclusion of consumers in the process.

The Green Network Energy