



## Ofgem Consultation on the RIIO-2 Framework

### E.ON consultation response

#### **Executive Summary**

- The next ten years will continue to be truly transformational across the energy value chain and the natural monopolies that will be governed by the RIIO-2 regulatory framework will encounter their fair share of this transformation. This framework will have an impact on many energy actors, as well as the end customer. As a supplier, low carbon generator and aggregator, we welcome the opportunity to comment on the proposals that have been put forward by Ofgem.
- We would like to make it clear that our response focusses on the electricity networks and system operator as we believe that these monopolies will undergo the most change over the next 10 years, especially with the separation of the electricity system operator.
- We agree with the proposals to give customers a stronger voice. It is important that a wide range of stakeholders have a voice in the development of business plans under RIIO 2. However, the user groups that have been proposed must have the available resource and expertise in order to properly scrutinise these plans. We do not agree that open hearings will provide an effective mechanism to solve contentious issues over and above the user groups. It should be for Ofgem to make decisions on areas of contention in line with its statutory duties.
- We support the move to a shorter price control. The world is moving too quickly for an eight-year control to remain credible throughout its life and five years is a happy medium in balancing this with the need for certainty from investors. We do accept that some elements of the business plans may benefit from a longer duration of control period, and would accept the concept of innovation activities being separated out into a longer control, enabling innovation investments to be made without the time pressure and uncertainty of a shorter control.
- We support the introduction of whole systems outcomes. As we move to decarbonise heat and transport, investment decisions will become far more complex and fewer decisions will be based around “build or not”. There will be several options, for example transmission build or distribution build; network capex or flexibility opex; or even gas network or electricity network. We believe that an independent system operator, especially on the electricity side, will be best placed to facilitate these decisions through open, transparent markets that allow different solutions to compete on a level playing field with each other.
- The primary objective of any price control is to ensure a fair deal for customers, and it is critical that the benefit share between regulated monopolies and customers is kept in the right balance. We welcome the proposals to ensure fair returns for networks. Out of the options provided, we believe that either “Constraining totex and output incentives” or “RoRE sharing factors” would provide the best deal for customers, as they seem to provide an appropriate balance between ensuring that network returns do not exceed the limits of fairness whilst providing networks with incentives to perform activities that will benefit customers.
- We look forward to Ofgem’s decisions around the RIIO-2 framework and hope to continue our engagement throughout the sector specific price control process.



## **Giving Customers A Stronger Voice**

### **Question 1**

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

1. It is important that a wide range of stakeholders have a voice in these plans now, from those with new business models to incumbents that are providing the investment in future solutions. It appears that this proposed model will allow good engagement with the establishment of the Customer and User Groups to challenge the business plans. The differences between these groups can take into account the different relationships between transmission network owners and their stakeholders and distribution network owners and their stakeholders.
2. However, it is important that any new groups created not only have the time to go through the plans but also the technical capability to understand them. The problem of information asymmetry can only be overcome if technical expertise sits on both sides of the fence.
3. Open hearings on areas of contention are unlikely to be an effective route over and above the stakeholder groups. It is not clear that this will bring any new engagement to the process and would simply be a re-statement of arguments already made. We believe that once both stakeholder groups and the Companies have submitted their views to Ofgem, it is up to Ofgem to make decisions on areas of contention in line with their statutory duties.

## **Responding to How Networks are Used**

### **Question 2**

**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?**

4. We do agree that the five year control seems a sensible approach. The world is moving too quickly for an eight-year control to remain credible throughout its life and five years is a happy medium in balancing this with the need for certainty from investors. We do not feel that a regulator would be able to design an eight-year control that would remain fit for purpose for all aspects of the price control.
5. With regards to whether some parts of network cost require separate, longer controls, we recognise that some investments may require a longer period in order to deliver cost reductions. Ofgem will need to very carefully scrutinise when this is necessary and will demonstrably benefit consumers.

6. Ofgem needs to remain mindful that there are risks associated with a five year price control such as forecasts of TNUoS always spanning price control periods, creating an inherent uncertainty at the back end. We nevertheless believe that the benefits of a shorter price control outweigh these risks
7. Innovation may also warrant a longer, separate period. As the price control nears its end, innovation projects that naturally take a longer time to deliver look undesirable from an investment point of view, with upcoming uncertainty. This could be addressed by providing a separate price control framework for innovation.

### **Whole System Outcomes**

#### **Question 3**

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

8. The role of the electricity system operator (ESO) will become very important. We believe that the ESO should have the best oversight of where an action could be taken in one sector to benefit another in the electricity system and should therefore have some role in coordinating such actions. We endorse this method, for example, in the transition from distribution network operator to distribution system operator where we believe that the ESO should lead the coordination of all market activity in order to reach optimal whole system outcomes.
9. We believe that initially, the ESO will be the driving force behind the whole systems approach. They will determine the decisions that are made (e.g. investment in copper or services at transmission/distribution) and should have appropriate incentives to optimise this process in its price control. These outcomes need to be linked to the price controls of the networks such that they are not disadvantaged. This implies that incentives for the networks should come in the form of offering their network based “solutions” to the ESO which can then compete against other options. This should incentivise networks to minimise the cost of their solutions in order to be successful and hence earn a return on the investment. Price controls can subsequently be adjusted to reflect this success in terms of allowed revenues.

#### **Question 4**

**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?**

10. Yes, we agree with this. Keeping them separate will allow Ofgem to put its full consideration into making each control as good and efficient as it possibly can, as long as the cost implications of this are kept to a minimum. We believe that the ESO price control can provide the whole systems link

which brings the separate network price controls into alignment, as the separate ESO price control should include incentives for ensuring that each part of the network is working providing solutions to optimise whole systems cost.

#### **Question 5**

**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?**

11. The scope of what is considered under a “whole systems” approach could be extremely large, encompassing all uses of energy across sectors i.e. including heat and transport. Whilst this might be a good long-term aim, in the short-term it appears sensible to have a more manageable scope by breaking this down into sub-systems. Therefore, the “whole electricity system” could be one focus for example. Under this approach, it would be important to:
- Ensure that actions taken by any system operator (transmission or distribution) is taken with due consideration of effects on other levels of the network so as to minimise the total costs to the customer;
  - Ensure that the framework is future-proofed such that, where possible, gas and electricity networks can make decisions that benefit each other in the future and minimise total energy network costs.

#### **System Operator Price Controls**

#### **Question 6**

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

12. Yes. They are two separate entities, so to ensure that the ESO is as independent as possible, it is important that the ESO should have its own price control. This will also leave open the possibility for further separating the ESO to create a truly independent system operator, an option that we believe it would be prudent to explore.

#### **Question 7**

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

13. We agree with alternative remuneration models for the electricity SO. Such a remuneration model should incentivise the delivery of a lowest cost provision of services to balance the system through encouraging the development of efficient markets to meet energy system and customer needs.

## **Network Utilisation and Investment Risk**

### **Question 9**

**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?**

14. As discussed elsewhere in this response, we believe that a role of the ESO will be to make decisions around the most appropriate solution for the efficient operation of the networks. If this role is taken up by the ESO, then perhaps there could be a process which assigns “stranding risk” to investments when making the decisions in, for example, competitive auctions. If these decisions were made independently of each participant offering solutions and it was a fair and balanced process to ensure a level-playing field, then this should go some way to helping reduce the risk of stranding.

## **End-use energy efficiency**

### **Question 10**

**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?**

15. We believe a central role of network companies should be to provide a secure and reliable connection to an integrated energy grid. However, an expanded role for the SO could allow it to design and develop flexible markets which can encourage a reduction in energy use by consumers in order to help manage the networks and create cost saving opportunities for consumers. These markets should be open and transparent to allow free participation for consumers, either directly (most likely for those larger consumers) or indirectly through a third party such as a supplier or aggregator. Energy efficiency measures should be able to compete on a level playing field with flexibility. There is a difficult question around baselining when considering efficiency improvements, as it is not clear what effect energy efficiency measures have on demand when compared to the counterfactual. This would need to be investigated further before any subsequent implementation.

## **Innovation**

### **Question 11**

**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?**

16. We agree that there is some value in separated innovation funding for those areas where the regulated entity could not be reasonably expected to undertake work as part of its business as usual operations. This absolutely should not include any projects that the company could not pursue in its business as usual operations from a regulatory standpoint, such as ownership of storage. Innovation projects should only cover areas that could, in the current and foreseeable regulatory environment, make the transition over to business as usual operations.

#### **Question 12**

**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)?**

17. We agree with these areas of reform.

#### **Question 13**

**What are the key issues we will need to consider in exploring these options for reform at the sector-specific methodology stage?**

18. A key issue to consider is the role of the regulated entity that will be receiving the money, and ensuring that their role in the regulated world is relatable to the role that they will perform within the innovation project.

#### **Question 15**

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

19. It is essential that innovation spending, as a whole, leads ultimately to benefits for the consumer. There have been some successes within the innovation schemes to date, however these projects tend to add gradual improvements to network operation instead of step changes. We broadly agree that the ENA innovation strategy outlines areas where network innovation should be focussed, and that these areas should give the best opportunity to deliver value to the customer. We especially believe that the areas of 'smarter networks' and 'whole system' have the potential to provide good value to customers.

20. In terms of transitioning to BAU, the application process for innovation funding should include an assessment on how such a transition could be achieved and the plans for getting there in the case that the project is a success. This should form part of the funding criteria. We believe that this will stop projects that cannot transition to BAU, either from a regulatory (such as network ownership of storage) or commercial standpoint from accessing innovation money and therefore wasting our customers' money.

### **Simplifying Price Controls**

21. We do not wish to answer any particular questions in this section, but do have some comments to make around simplifying price controls.
22. There is benefit to ensuring that price controls are as simple and transparent as possible so that the costs that are incurred by networks can not only be understood by technical experts in the networks themselves, but also by other participants in the energy system. This will be increasingly important as DSOs emerge and other participants begin to offer solutions to compete with traditional network solutions.
23. We believe that one key change would be towards a much stronger link between the cost allowances in the price control, and the charges that are used to recover these. In effect, this would mean having a price control which clearly indicates which cost elements are variable and over what timescales. It would then indicate the charges that reflect these cost elements. Users would then be able to more clearly see where there is value in taking actions which deliver system cost savings which can be directly passed on to customers.

### **Ensuring Fair Returns**

#### **Question 36**

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

24. The CEPA analysis is a robust independent assessment of the cost of equity and we see no reason to dispute its findings.
25. Delivering energy networks can be complex and will be subject to a large amount of change over the coming years. However, it is also a regulated monopoly industry, with regulated returns, and therefore relatively secure investment. For example networks in particular can, and do, avoid risk within funding new connections by passing liabilities over to developers. With this in mind, it is reasonable to set an equity broadly in line with similar industries, but reflects the lowered risks for operating in this market.

#### Question 41

**Do you agree that we should move away from RPI for RIIO-2?**

26. Yes. Most indexation for other processes has now moved away from RPI to CPI or CPIH, so it seems practical to do so for network regulation too. This should reduce the overall costs of the networks for customers and should therefore be seen as a beneficial change in the price control.

#### Question 45

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

27. We have some high-level views on each of the options presented:

- **Hard cap/floor** – we do not believe that this option would result in a good deal for consumers. Whilst easy for networks to understand, a hard cap would disincentivise them from delivering value past a certain point. We believe that most network companies have a desire to deliver for customers if rewarded. Completely removing rewards after a certain point seems to create a detriment and moves the system closer to rate of return regulation.
- **Discretionary adjustment** – Whilst relatively simple for the regulator to perform, we do not believe that discretionary adjustment would optimise customer benefit. There would not be sufficient transparency and the uncertainty created by this option would likely lead to a reduction in investor confidence in the sector, potentially leading to an increase in cost of capital. This could add cost to consumers making it a less attractive an option.
- **Constraining totex and output incentives/RoRE sharing factors** – these two options seem to be the fairest to us, on balance. We believe that maintaining the principle of incentives whilst reducing its value provides a fair balance between investors and customers. Depending on the level of the incentive this should still enable the network to deliver high value projects for consumer benefit. We believe that either two of these options would improve on the current system whilst being most likely to minimise the potential for unintended consequences.
- **Anchoring returns** – This option seems to create a fairness issue between network companies whereby a company operating within normal margin boundaries could be punished because another has reached an unfair margin. This does not seem like a pragmatic option and is likely to have a detrimental impact on investor confidence and therefore cost of capital.





**E.ON – May 2018**