



RIO-2 Framework Consultation - ADE Response | 2 May 2018

Context

The Association for Decentralised Energy (ADE) welcomes the opportunity to respond to the **RIO-2 Framework Consultation**, which sets the framework for the next price control for operation of the electricity and gas networks.

The ADE is the UK's leading decentralised energy advocate, focused on creating a more cost effective, efficient and user-orientated energy system. The ADE has over 120 members active across a range of technologies, and they include both the providers and the users of energy. Our members have particular expertise in combined heat and power, district heating networks and demand side energy services, including demand response and storage.

This document provides the ADE response to the consultation questions most relevant to our members.

Chapter 4 – Responding to how networks are used

Length of price control

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

The ADE welcomes the proposal to allow stakeholders to provide input and challenge to company plans. If implemented correctly, this could strengthen the ability of industry to scrutinise business plans and hold network operators to account. It is essential, however, that representatives are selected from a range of different stakeholders, including new and emerging participants in the energy system. This will enable a broad range of views to be represented, not just those of traditional incumbents, encouraging innovative approaches. We would also note that while, if structured correctly, the challenge groups will be a valuable means of allowing stakeholder input, it is important that Ofgem maintain final responsibility for holding network operators to account. Consumer challenge groups must be an addition to Ofgem's subsequent scrutiny, not a replacement for it.

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?

- *What type of cost categories should be set over a longer period?*
- *How could we mitigate the potential disruption this might cause to the rest of the framework?*
- *What additional measures might be required to support longer-term thinking among network companies?*

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

The ADE welcomes the proposal to move to a five-year price control. It is important that the exemptions for longer timescales, such as asset replacement programmes, be tightly defined and monitored, in order that misaligned incentives are not created to pursue asset replacement at the expense of more innovative flexibility solutions. While longer timescales may be appropriate in limited scenarios to allow for more certainty around investment budgets, the bar for a timescale extension should be set high to ensure these represent the exception, rather than the rule.

An area that Ofgem should consider is how the combination of nearer-term and longer-term investment horizons will interact as network operators make their decisions on investment and whether this interaction risks creating unintended and possibly inefficient incentives.

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

The ADE strongly welcomes the use of the price control to incentivise whole system outcomes. However, it is important to acknowledge the complexity of this ambition.

We would welcome Ofgem conducting a detailed assessment of how the price controls will facilitate whole system outcomes, how this improvement will be measured and assessed, and what measures will be taken if there are signs that these outcomes are not being achieved. A narrow definition of the network operators' role in encouraging whole system outcomes is particularly important to ensure they continue to participate as neutral market facilitators.

To be significant, we consider that the price control will need to establish a clear commercial value to developing a whole system outcome. As the RIIO-2 settlements will be structured by network operator area and reinforcement must remain a core part of the framework, it is very important that the financial value the network operator sees through engaging in a whole system outcome where the intervention may well ideally sit in a different network area is greater than the value they see if the intervention were to remain theirs.

One effective means by which the price control framework is likely to enable whole system outcomes is by incorporating mandatory assessment of non-reinforcement options as part of the NOA and of any analysis that the SO and DNOs conduct in relation to network planning and reinforcement. If these analyses demonstrate that non-reinforcement options provide better value for money, implementation should be made mandatory.

The analysis could be structured along the lines of the integrated resource plans (IRP) that several U.S. states require from utilities, where demand-side options must be considered on an equal footing with supply-side options¹. The mix of resources that produces the most reliable,

¹<http://aceee.org/policy-brief/utility-initiatives-integrated-resource-planning>

least-cost plan is then selected and pursued. IRPs are particularly effective in driving whole system outcomes when combined with Energy Efficiency Resource Standards².

Another useful approach may be to follow that of the System Operator's Forward Programme, where there is an explicit commercial incentive to encourage whole system outcomes – even if the intervention sits, for example, at distribution.

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?*

Ofgem define 'whole system outcomes' in the consultation document as "Outcomes necessary to ensure that the energy system as a whole is effectively coordinated to deliver best value for consumers in response to the energy transition".

The ADE welcomes Ofgem's focus on whole system outcomes, particularly the acknowledgement that there could be increasing scope for distribution level solutions to transmission network constraints and vice versa. We also welcome the focus on the potential for increasing interaction across the electricity and gas networks, particularly in the area of heat decarbonisation. We believe that the following areas should be focused on for the RIIO-2 period:

- Distribution solutions for UK-wide grid management, with greater use of Demand Side Response
- Grid services from heat networks, focusing not only on the gas grid but also on heat networks

Within these areas, the focus should be firstly on the way in which RIIO-2 supports the creation of markets at distribution that do not presume the DSO as the sole buyer at distribution and are simple to stack with services provided nationally through the Capacity Market, Balancing Mechanism, TERRE and balancing services. Secondly, the focus should be on the way in which network operation and long-term network planning is consistent across all voltage levels and explicitly reflective of solutions at different levels. The commitments made in the System Operator's Forward Programme regarding the NOA are welcome in this regard. Thirdly, network charges should be clear across voltage levels and should provide financial incentives to generation and demand providing a system benefit (for example, avoiding reinforcement through flexibility or supporting local balancing between generation and demand). We welcome the Charging Futures Forum work in this regard.

System Operator price controls

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

The ADE agrees with the view that the SO price control should be separated from the TO price control. As the separation develops, the roles of the two bodies will diverge markedly, meaning that two different sets of incentives are likely to be necessary. It will also provide greater opportunity to incentivise the SO to pursue whole system outcomes.

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

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

²<http://aceee.org/blog/2014/12/irp-vs-eers-there%E2%80%99s-one-clear-winner->

The ADE agrees that Ofgem should be considering alternative remuneration models for the electricity SO. As noted in the consultation, RAV-based models are more appropriate for capital-intensive companies that build and operate assets. As the SO increasingly becomes a service provider, an alternative remuneration model that incentivises a greater focus on service provision is most likely to be suitable for the SO. It is crucial that this model incentivises the need to treat flexibility on a par with reinforcement. The remuneration model should relate closely to incentivising the deliverable objectives in the SO's Forward Work Programme.

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?*

The Clean Growth Strategy aims to develop a package of measures to support businesses to improve their energy productivity by at least 20% by 2030. According to the Strategy, up to £6 billion could be saved in 2030 through investment in energy-efficiency technologies in the commercial and industrial sector.

As discussed above, requiring network companies to produce integrated resource plans (IRPs), ideally in combination with a robust set of Energy Efficiency Resource Standards, would be an effective way of reducing energy use by consumers.

Network companies should also be obliged to provide more granular and real-time information on network areas likely to become stressed to help potential flexibility providers; this should form a minimum standard for encouraging a reduction in energy use by consumers, not a stretch target.

While the ADE welcomes the focus on end-use energy efficiency, we would like to see more detail on what role network operators would be expected to play in encouraging it. Without detail and well-defined boundaries, there is a risk of unintended consequences resulting from this approach.

Chapter 5 – Driving innovation and 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 RIIO-2 framework?

The ADE agrees with the proposal to retain dedicated innovation funding but believes that innovation projects should be assessed against more explicit criteria of carbon savings, network reliability and use of non-build solutions.

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)?

The ADE strongly supports these areas of reform and would welcome more detail in these three areas. We particularly welcome the attempt to align innovation funding more closely with public sector funding and with key areas of focus for the smart transition.

There is a view that the innovation competitions have worked somewhat in isolation from the broader price control. In setting RIIO-2, the ADE would like to see more ambition in how the framework will support successful innovation trials being implemented as Business As Usual.

Competition

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

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

We welcome Ofgem's commitment to facilitate and promote market-based approaches to managing the energy systems and driving whole system outcomes. We agree that extending the scope of competition has the potential to deliver consumer benefits and facilitate the energy transition.

Chapter 7 - Fair returns and financeability

The ADE does not have detailed comments on this section, but we welcome Ofgem's focus on ways of guarding against higher than expected returns while retaining an incentive-based framework. Improvements to the assumptions and methodologies relating to inflation and cost of capital are likely to be crucial in achieving this; we look forward to further details around these improvements.

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