

Energy UK response to Ofgem's RIIO-2 Framework Consultation

9 May 2018

About Energy UK

Energy UK is the trade association for the GB energy industry with a membership of over 100 suppliers, generators, and stakeholders with a business interest in the production and supply of electricity and gas for domestic and business consumers. Our membership encompasses the truly diverse nature of the UK's energy industry – from established FTSE 100 companies right through to new, growing suppliers and generators, which now make up over half of our membership.

Our members turn renewable energy sources as well as nuclear, gas and coal into electricity for over 27 million homes and every business in Britain. Over 730,000 people in every corner of the country rely on the sector for their jobs, with many of our members providing long-term employment as well as quality apprenticeships and training for those starting their careers. The energy industry invests £12bn annually, delivers £88bn in economic activity through its supply chain and interaction with other sectors, and pays £6bn in tax to HMT.

Introduction

Networks are key to facilitating rapid energy industry change. This includes accommodating low carbon, renewable energy whilst ensuring security of supply, enhancing flexibility and the transition to a smarter system. This is required whilst taking into account the costs incurred by an increasingly varied range of network users and customers. All of these aspects make setting levels for the new RIIO-2 price control hard to predict.

It is important to cover lessons learnt from the RIIO-1 process and, in the face of a changing energy industry, to avoid 'locking in' a specific RIIO-2 approach for too long. The new price control should be able to respond to change and the ways in which the networks are increasingly being used. At the same time, it is important to generate the investment needed for maintaining and updating the networks.

Energy UK's response focuses on a select number of questions put forward in Ofgem's consultation document.

Some initial, high-level points are raised which Energy UK notes as being key to a successful price control, with our response broadly shaped around these. Proposals put forward by Ofgem with largest support amongst our membership are focused on. Some are discussed in greater detail, where Energy UK notes that further consideration by Ofgem is required.

Aspects key to a successful price control

Energy UK believes that the following areas are key for a successful price control. Price controls should:

- Represent good value for money for consumers;
- Incentivise fairness and efficiency for network owners, operators and users;
- Enable stakeholders to engage effectively with the process;
- Be implemented in a way that minimises uncertainty and translates into stable, transparent and predictable charges; and
- Successfully accommodate the energy transition with a focus on whole system outcomes

Effects on Customers

Whilst it is acknowledged that customers (end users of energy) are at the heart of Ofgem's considerations for the RIIO-2 framework process, Energy UK notes some omissions within Ofgem's consultation document. In particular, the effects of decisions involving RIIO-2 on various customer types (from domestic to SMEs and industrial users). More importantly, there is no reference of the potential effects on vulnerable customers who are often most impacted by the unintended or unpredictable costs of network activities.

More generally, it is important for any decisions around the RIIO-2 price control to help deliver both short and long-term customer interests.

Appropriate notice periods & transparency

Energy UK highlights the risk of a potential 'cliff-edge' effect on customers' bills, in relation to supplier pass-through costs. This specifically relates to customers on non-pass-through contracts, where suppliers will forecast Network Charges for periods where actual tariffs are not available.

Whilst allowed revenues are predicted to decrease under RIIO-2, the extent of that reduction will not be known until very late in the process. This does not provide suppliers with adequate notice to accurately price resulting Network Charges from the RIIO-2 process into customer contracts. Prior to final determination of Allowed Revenues, suppliers will, therefore, need to take their own view of what each Network Operators allowed revenue will be. Despite RIIO-2 aiming to provide protection for customers, the late agreement of allowed revenues may result in larger than necessary bills to customers if actual revenues are lower than supplier forecasts.

Energy UK notes two concurrent actions for consideration, to help reduce the extent of this 'cliff edge' effect by allowing for greater transparency:

1. Network Operators should be instructed by Ofgem to overlay the RIIO-2 methodology within their business plans and publish, in a standard format, an 'Allowed Revenue' value for each year of the price control. This would provide the market with a consistent view of what the Allowed Revenues would be, should these business plans be approved.
2. Ofgem should fix the revenues that go into the first year of RIIO-2 Network Tariffs ahead of the Final Determination Date. Any adjustments to this (positive or negative) once the actual Allowed Revenues are confirmed, could then be spread over the remaining years of the price control. This approach was used by Ofgem prior to RIIO-ED1 when revenues to be used for tariff purposes were fixed in July prior to final determination.

These approaches will enable networks to present a view from their business plans before Ofgem fixes at the Draft Determinations stage.

Section 3: Giving consumers a stronger voice

In relation to consumer engagement, Energy UK understands that Ofgem proposes to:

- **For Distribution:** establish an independently chaired Customer Engagement Group to challenge companies. This group will report to Ofgem on how it has reflected the needs and preferences of local users and consumers.
- **For Transmission:** establish an independently chaired User Group to provide input and challenge to business plans. The group will provide a report to Ofgem on areas of agreement or disagreement across the companies.
- **Across both distribution & transmission:** establish an independently chaired RIIO-2 Challenge Group that will assess the business plan proposals in both sectors and provide a report to Ofgem on their findings.
- **More widely:** set up Open Hearings once business plans have been delivered to hear arguments for and against plus any topics of particular contention.

Energy UK puts forward the following points for consideration by Ofgem in relation to the consumer engagement process:

- Whilst wide stakeholder input is viewed positively and could help increase transparency, it is key for Ofgem to retain overall responsibility for final decisions involving business plans.
- The RIIO-2 Challenge Group should challenge Ofgem's thinking *in addition to* company plans.
- There is support for Open Hearings as an enhancement of transparency and engagement. Third parties should be able and encouraged to take part.
- Ofgem should give consideration to how areas of contention can be dealt with as a priority. Should this be via additional groups (e.g. Open Hearings), or via efficient use of existing groups (e.g. the Ofgem Challenge Group) which should consist of independent parties representative of a wide range of stakeholders.
- Once both stakeholder groups and companies have submitted their views to Ofgem, it is ultimately up to Ofgem to make decisions on areas of contention in line with its statutory duties.
- A Stakeholder Working Group should be set up to provide stakeholders with a clear mechanism for feeding into the detailed stages of price control development (e.g. licence drafting stage).
- Ofgem should be upfront and transparent about the extent of influence that all groups have (i.e. state this clearly) so that the level of investment inputted by stakeholders on these groups is proportionate to their influence.
- Ofgem should consider its own stakeholder engagement approach and learn from any lessons in RIIO-1. For example, Ofgem should seek to take onboard advice from stakeholders when flagging particular issues early on.
- Ofgem should action and provide reassurance that it is carrying out its own impartial research in addition to company customer engagement and User Groups and separately to the Challenge Group and Open Hearings. For example, analysis on the historical performance of companies and more forward-looking analysis beyond that carried out by Cambridge Economic Policy Associates (CEPA). The continued use of workshops should be considered.
- Transparency and reassurance regarding the governance, constitution and efficiency of these groups should also be provided. Is this, for example, one per company or one per network, including gas? This is important if there is to be closer cooperation between transmission and distribution companies going forward.
- The final format of these consumer engagement groups should not exclude particular areas or sub-groups, or conversely only allow the voices of a few to be heard.
- Any information or documentation shared in these groups should adhere to competition law.
- Thought needs to be given to the geographical location of network owners (e.g. gas).
- If the Electricity System Operator (ESO) ends up with a separate price control, this should be accompanied by its own stakeholder engagement groups to ensure the same level of scrutiny and influence is applicable to the ESO's business plan as is Transmission and Distribution business plans.
- Is there scope for the Gas Distribution Networks (GDNs) to hold joint sessions where issues of common interest to stakeholders are considered?

Section 4: Responding to how networks are used

Length of price control

Ofgem proposes a reduction in the length of the price control from 8 years currently used in RIIO-1 to 5 years for RIIO-2. There is broad support for this move to a shorter price control period (with no Mid-Period Review (MPR)), which we believe will help create transparency and simplicity around what set incentives are.

Energy UK believes this approach provides a good balance between the longer-term certainty required for investment given the nature of network assets; versus the uncertainty that relates to the fast-paced change of the energy system. We believe this price control length allows for greater flexibility and better protects against previously extended effects on consumers.

Energy UK and its members have discussed potential activities, projects or programmes where it could be deemed necessary to set allowances over longer (or indeed shorter) timescales. There are concerns, however, that a multi-track arrangement could add unnecessary complexity to the framework process.

Energy UK advises that any justifications for differential timescales to the 5-year period proposal should be scrutinised and carefully considered.

Any allowances set over a longer period than 5-years should retain the possibility of a MPR so adjustments can be made if necessary, this will protect consumers from allowances or targets where assumptions may have been incorrectly set at the start of the RIIO-2 period.

Aligning price controls

Whilst we appreciate the amount of resource required in setting a price control whilst aligning other price controls would be significant, in an ideal world price controls would be aligned to better facilitate whole system outcomes. This would maximise efficiencies through the interaction of price controls and deliver better value to consumers.

At this time however, Energy UK does not believe it is practical to align price controls. Mechanisms to allow price controls to interact with one another should be designed in any case.

Whole System Outcomes

Networks are key to facilitating rapid energy industry change, including accommodating necessary low carbon and renewable energies, technologies important for a secure supply (e.g. those that provide baseline supply), options for enhancing flexibility and the transition to a smarter system. It is also important for networks to provide adequate information (e.g. to flexibility providers) to promote alternative solutions. All of this is required whilst taking into account the costs to an increasingly varied range of network users (customers).

The “whole system” can be defined as the point of generation to the point of usage by a consumer. However, technological shift is changing the nature of this in terms of players, value chain elements and links, and the parts played by each element. Price controls are about forecasting and trying to put in place the optimum network to facilitate efficient outcomes for the benefit of consumers. Putting all these points together shows that flexibility is needed and frameworks for assessing whole system outcomes could become overly complex in the search for the ‘optimal’. This should be carefully considered in light of the RIIO-2 approach.

In the interests of whole system outcomes, Energy UK is supportive of a flexible approach to the running of networks and related incentives. This could be for example, responding to the following changes in a timely and stepwise manner:

- Allowing alternative solutions to compete on a level playing field with traditional network reinforcements when addressing network constraint issues; and
- Increasing EV penetration at the distribution level as a first step.

In relation to power issues, RIIO-2 should include a focus (for example) on the Electricity System Operator (ESO) coordinating the power system effectively to least cost investment, whilst beginning to look at wider whole system interactions between gas and electricity. Future price controls could then continue to develop this.

It is queried whether Ofgem could implement obligations or metrics that incentivise network companies to consider alternative options to traditional ones. This should focus on arriving at the *right* whole system outcome from the consumer perspective, which may of course differ to an ideal outcome from a networks perspective.

Ofgem should also guard against incentivising the delivery of sub-optimal whole system solutions, whereby these solutions are delivered and yet unduly rewarded.

More widely, network companies should be rewarded for making better use of the existing network where possible, rather than building new infrastructure. One mechanism to achieve this is to make the ratio between maximum capacity and the average load on a network (‘load factor’) a primary metric for adjusting network company revenues.

Energy UK supports the unbundling rules which separate network operators from users, particularly in relation to energy storage, DSR and generation where operators may not directly or indirectly own these assets.

Separate price controls – ESO / TSO

Energy UK supports the proposal for a separate price control for the Electricity System Operator (ESO) and the National Grid Electricity Transmission Operator (+gas System Operator). This is unavoidable given the legal separation of the two businesses and their responsibilities. Traditional arrangements would no longer work for a standalone ESO and there is agreement that this links into the Incentive Framework for the ESO. There is also less risk of double incentives being awarded.

The role of network companies in encouraging energy efficiency

Energy efficiency is an enduring solution to help consumers reduce their energy consumption, improve the comfort of their homes, and is central to achieving the Government's 2030 fuel poverty and 2050 carbon reduction targets.

We do not consider it to be the role of network companies to be involved in direct contact with end consumers on energy efficiency, as this is not part of their regulated business.

Energy UK strongly believes that the fairest and most progressive method of funding, promoting and delivering energy efficiency programmes is through general taxation.

Section 5: Innovation & Competition

Innovation

Energy UK is supportive of collaborative innovation that is directly focused on improving and facilitating the future energy system and related whole system solutions. Innovation projects should demonstrate how they are going above and beyond with a clear vision of the benefits that will be delivered to consumers. Innovation within network companies should be an inherent way of working. Innovation projects carried out under the Low Carbon Networks Fund (LCNF) should be incentivised as business as usual under RIIO 2.

Innovative ideas that have been successful under existing innovation funding should be recognised in upcoming expenditure allowances to ensure the benefits of these are fully realised. Innovation arising from any new innovation funding should facilitate genuine new learning and advancement, including in relation to heat, as well as electricity, networks.

Competition

Competition is supported by Energy UK and its members, particularly where it delivers effective competition with clear benefits for consumers. Barriers need to be removed where they prohibit effective competition and new market players need to be allowed to enter the market, in order to help deliver services at best cost to the consumers.

A careful balance is needed, however, between reduced overall cost and *value for money* in the long term. The cheapest option may not always be the best value for money solution.

Protection is also needed against any aspects of competition that introduce uncertainties or delays and more specifically, competition needs to be designed to quickly expedite the implementation of solutions (for example that ease constraints).

Current and future levels of competition involving DNOs and IDNOs should be taken into account. There are some effective models of competition already in place and these should be recognised.

Section 6: Simplifying the price controls

The evidence provided in the consultation illustrates that fast-tracking for transmission has not been effective and is unlikely to have delivered benefits to consumers, as such we would support the removal of fast-tracking for transmission where there is little competition between network companies.

Section 7: Financeability & Fair Returns

Energy UK acknowledges the inherent complexity surrounding the setting of price controls and related revenues. Having failsafe options in place is, therefore, important for consumer protection, given the higher than expected returns experienced throughout RIIO-1.

Given the breadth of our membership across suppliers, generators and network operators, Energy UK is unable to comment in detail on the specific options set out regarding financeability and fair returns. Many of our members will be providing individual responses, although Energy UK makes some broad comments as follows:

- It is important that the long-term interests of customers and investors are aligned.
- In regards indexation, we support a move towards CPI or CPHI in place of RPI.
- Keeping regulated monopolies under the right amount of scrutiny alongside appropriate indexation is key to ensure undue incentives are avoided can help to ensure fair returns.
- A decision as to what a 'fair return' is and allocating devices or a process to ensuring fair returns is ultimately Ofgem's role as the regulator. This should be actioned following transparent consultation with stakeholders to ensure legitimacy.
- Greater accuracy in setting predictions at the start of the RIIO-2 framework process will reduce the need to utilise the failsafe mechanism outlined in Ofgem's consultation document. This relies on good quality research, analysis and stakeholder input which Energy UK has provided thoughts on in Section 3.

Section 8: Sector-specific issues

In relation to electricity distribution, facilitating the use of non-traditional solutions (i.e. through flexibility providers) is key.

In relation to Gas, Energy UK raises the following points for Ofgem to consider:

- In relation to lessons learnt from RIIO-1, well-designed uncertainty mechanisms are key. Ofgem should avoid defining particular investments that network operators should take, to avoid a repeat of issues arising from this approach for certain Gas transmission investments in RIIO-1. In this context, this led to revenue allowances being adjusted later in the price control period in order to return money to customers.
- Consideration should be given to the current uncertainties around the future of gas and how these can be handled as part of the RIIO-2 process, given the expected sector-specific guidance due later this year. This consideration should also take into account decommissioned points in the gas network.
- How do considerations around the RIIO-2 framework fit with the Fuel Poor Network Scheme?
- As a wider point, can the issue of alignment of the gas year and the regulatory year be revisited to help further ease complexities?

These queries additionally highlight the need to consider complex consequences as baseline allowances are being reviewed.

Energy UK welcomes the opportunity to further discuss the points raised within this consultation with Ofgem. Should you require further information or clarity on the issues outlined in this response then please contact: helen.thomas@energy-uk.org.uk