The Voice of the Networks

6 June 2016

Sylvia Da Silva
Ofgem,
Canary Wharf,
10 South Colonnade,
Canary Wharf,
London E14 4PU

Dear Sylvia,

Report by EY "Evaluating the need for, and strengths and weaknesses of, fair returns mechanisms for RIIO-2"

ENA's response to the RIIO-2 Framework Consultation highlighted work underway commissioned by ENA to consider the five 'failsafe' measures set out under the consultation. This work is now complete.

Please find enclosed a copy of the above report that we hope will provide a useful contribution to the evidence base and assist Ofgem in its consideration of this aspect of the RIIO-2 Framework.

EY's key conclusions are:

- RIIO-1 has, in broad terms, been a success over the initial few years of the eight year period, with significant benefits to all stakeholders involved;

- Energy networks have been rewarded for this success and RoRE is projected to exceed the allowed cost of equity. It is, however, not clear that these returns are higher than expected;

- The RIIO-1 price controls are not yet complete, so we do not yet know what the outturn RoRE over RIIO-1 will be. There are also mechanisms that are yet to be applied that could impact network companies' RoRE; Neither does RoRE take into account a number of other financial factors;

- Ofgem's projections of RoRE are, in most cases, within the RoRE ranges which Ofgem estimated at the RIIO-1 price controls;

- Assessment of the fair returns mechanisms tends to suggest that **none of these mechanisms is clearly going to create net-benefits for consumers**: while there may be some benefits for consumers from some of these mechanisms, these would need to be weighed against any reduction in value for money that would flow from reduced incentives to innovate and improve performance as well as any increase in the cost of capital (for some of the mechanisms) caused by increased perceptions of risk;

- The mechanisms present some practical challenges to design and implement them, and none of the mechanisms ultimately targets the root cause of rates of return which are perceived to be too high i.e. incentive mechanisms and cost allowances that are not robustly determined;

- It is not clear there is a need to introduce a fair returns mechanism for RIIO-2 or that it would be beneficial to do so. Existing tools, if calibrated robustly, may be able to address the problems some stakeholders have perceived in relation to RIIO-1; and

- If Ofgem chooses to pursue the idea of introducing a fair returns mechanism for RIIO-2 then a full assessment of each of the possible fair returns mechanisms, including how these mechanisms deliver the objectives of the price controls better than robustly applying existing tools, needs to be undertaken before any decision is taken to introduce fair returns mechanisms.

ENA reiterates its previous comments regarding RIIO-2 and the need for it to best enable the energy sector to meet the future challenges of an uncertain investment and growth future. We believe that this means taking a holistic approach in setting stretching targets whilst providing a stable regulatory regime in which investors can have confidence. We recognise there is scope for making refinements to the RIIO framework. However, we continue to strongly believe that diligent application of the existing RIIO 'tool kit' with any necessary evolutionary refinements will result in the best all-round outcomes for consumers.

We therefore ask Ofgem to consider carefully whether adopting any new approaches that in general seek to remove or reduce any risk associated with forecasting financial aspects of the price control and 'fail-safe' measures that restrict the level of achievable outperformance is on balance the best all-round approach. It should be recognised that they have associated costs and benefits and carry risks and uncertainties. We think this needs to be weighed carefully against applying well understood RIIO-1 mechanisms that Ofgem is able to calibrate using several years of sector data on costs and performance.

The proposed shorter 5-years price control will assist in reducing forecasting error as would the use of existing uncertainty mechanisms. For example, downsides created by ex-post type mechanisms that would limit and/or adjust returns could have a cooling effect on RIIO incentives designed to drive innovation, efficiencies, costs reduction and higher standards of customer service. These risks and their impacts would also manifest themselves at a time when companies will be required to adopt behaviours needed to adapt to, facilitate and enable major changes to our energy system.

Once the RIIO-2 team have had time to consider the EY report we would be very happy to meet, should you find that useful.

Please do not hesitate to contact me to make any necessary arrangements or if there is anything ENA can do to assist.

Yours sincerely

David Smith
Chief Executive

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