

Energy Networks Association Response to Ofgem's RIIO-2 Framework Consultation

Introduction

- 1.1 Energy Networks Association (ENA) represents the companies that operate and maintain the gas and electricity grid network in the UK and Ireland. Serving over 30 million customers, they are responsible for the transmission and distribution network of 'wires and pipes' that keep our lights on, our homes warm and our businesses running.
- 1.2 Understanding the track record of our energy networks since privatisation in 1990 is key to understanding the role that they can play in delivering high quality energy networks services to consumers consistent with helping the Government meet its short, medium and long-term objectives for energy policy.
- 1.3 Our energy networks are recognised around the world for their strong track record of safely and securely providing the UK with the gas and electricity it needs in three key areas.
 - i. *Trusted performance* - The average gas customer will experience an unplanned interruption once every 140 years. For electricity customers, since 1990, there has been a 50% reduction in number of customer interruptions, and a 60% reduction in length of customer interruptions.
 - ii. *Reduced costs & increased investment* - Network costs are now 17% lower than they were at the time of privatisation and are projected to remain flat, and in some areas fall, into the next decade. By 2020, the UK's energy networks will have attracted some £80 billion of investment since 1990. A significant proportion of which is spent with UK companies. New investment in the networks is forecast at £45bn between 2017 and 2023.
 - iii. *Energy innovation* - Independent research carried out by Pöyry has shown that innovation projects by local electricity Distribution Network Operators (DNOs) could deliver up to £1.7bn of benefits by 2031. Additional benefits will flow from the innovation undertaken in the other network sectors.

Recognising the value of a Whole-System Approach to delivering a secure, decarbonised energy system at lowest cost to consumers

- 1.4 Our members welcome Ofgem's recognition of the whole systems approach and its proposal to focus on the levers within the price control that could support the delivery of whole system outcomes across the energy system for the benefit of consumers. We believe the greatest efficiencies in delivering a secure, low-carbon sustainable energy system will be best realised through the adoption of a 'Whole-System' approach. For us a Whole-System approach means looking at optimal network investment and operational decisions for the whole energy network, not just the individual parts in isolation. It also means considering interactions across energy vectors (e.g. heat networks, power, energy storage and transportation) so that wider options and consumer value can be taken into account. This work is supported by consideration of the connections, data links, interfaces, coordinated

planning opportunities, potential impacts and shared learnings across transmission and distribution, electricity and gas networks and other energy vectors, both currently and in the future.

- 1.5 Our members believe that if our power, heat, transport and waste sectors are all interdependent, then so must the solutions for their decarbonisation. A Whole-System approach is based on our energy networks using new smart technologies to work together in an integrated way, building on the strength of our existing gas and electricity network assets. This is well illustrated by the fact that over 80% of peak energy usage is currently derived from gas, without the gas grid there is simply not enough energy for the UK to function, or the means to transport that energy to end users during peak periods. With the population expected to increase by 22% by 2050 and other developments such as increased uptake of low emission vehicles, total energy demand will increase significantly. We therefore need to look at the energy system as a whole, by delivering on future investment and developing smarter solutions needed to meet our energy objectives and clean growth.
- 1.6 We therefore believe the approach adopted for the regulatory framework under RIIO-2 and the next round of price controls, not only needs to evolve in response to the experience and lessons learnt under RIIO-1, but also needs to take into account and be consistent with wider energy policy and its objectives. Central to this is ensuring the GB networks are able to continue to attract significant levels of investment needed over the next decade and beyond, and at lowest cost to the consumer. We urge Ofgem to keep this central to any considerations within the context of this consultation and particularly consider asymmetries of risk that may attach to particular approaches. We also encourage Ofgem, when coming to final decisions, to consider carefully the interactions and relationships between the various aspects of the RIIO package and the regulatory environment it provides in its totality.
- 1.7 We warmly welcome the opportunity to respond to the RIIO-2 Framework Consultation.
- 1.8 This response sets out a collective view of some key common principles, points and areas of focus for ENA and the gas and electricity networks industry. The response sets out those areas where there is broad agreement between members. We have aligned our response below to the sections of the consultation document for ease of your consideration.

Key Points

Our members wholly support setting a framework that delivers a 'fair deal' for both consumers and investors. RIIO-1 was the first time that the RIIO principles have been used. The effectiveness of the RIIO-1 framework increased through experience of its application culminating in the RIIO-ED1 slow track approach which is working well. We 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 and the country. We must continue to utilise our world class gas and electricity grids to ensure that energy and societal needs are efficiently met.

The future framework for RIIO-2 needs to create the conditions to attract new investment and drive behaviours to deliver network services which meet the needs and wants of a wide range of consumers consistent with advancing the UK's wider clean growth energy policy.

Focusing on capping returns to investors regardless of levels of performance risks eroding incentives to invest, innovate and improve performance for customers. Any move to an ex-post approach would be most damaging to investor confidence and the principles of the RIIO framework.

Ofgem has stated its aim is to develop a low risk and low returns RIIO-2 framework. At present it's not clear how this will be achieved as many of the proposals in the consultation increase risk.

Ofgem needs to set price controls based on sector specific and individual licensees' circumstances and their specific merits, without undue precedent being set from other parts of the process.

RIIO-2 needs to enable the energy sector to meet the future challenges of an uncertain investment and growth future, setting stretching targets whilst providing a stable regulatory regime in which investors can have confidence. This needs a holistic approach driven by objectivity and evidence. Where levels of return are a focus the metric used should be accurate. The current RORE is incomplete.

RIIO-1

- 1.9 Network regulation under RIIO-1 has been a success story for consumers with network costs reducing and service to customers improving as recognised by the CEPA review of RIIO-1. We believe the framework for network regulation is working well and so any future developments should be built around similar objectives and goals to the RIIO-1 framework as these are customer and stakeholder focussed, and are now understood and trusted by investors.
- 1.10 This approach is most likely to continue the success of the UK's energy networks in attracting investment, reducing consumer costs and delivering new sources of low carbon energy. Incentive regulation in Great Britain is widely recognised as being very effective whilst network companies continue to deliver world class service quality. Eurostat datasets show that GB network costs for both domestic and industrial consumers are lower than or comparable with other major EU economies (Germany, France & Italy). Service standards have improved markedly under the price control framework since privatisation in 1990, with the RIIO framework recognised as an exemplar and replicated across other jurisdictions. Network costs are now 17% lower than they were at the time of privatisation and are projected to remain flat, and in some areas fall, into the next decade. By 2020, the UK's energy networks will have attracted some £80 billion of investment since 1990 which benefits the UK supply chain. New investment in the networks is forecast at £45bn between 2017 and 2023.
- 1.11 Below we provide comment that reflects our members' 'in-principle' positions on the key proposals set out in the consultation:

Giving consumers a stronger voice

2. Our response to the RII0-2 Open Letter published last year¹ encouraged Ofgem to consider the establishment of panels who represent end-consumers interests, operating over the course of the next price controls. We recommended these panels are used to help inform the assessment of RII0-2 Business Plans, and through evaluation of RII0-1, identify approaches that have delivered outstanding results and how these may be further developed and adopted recognising cross-sector and regional differences. We also suggested that due to regional differences ENA members will still need to undertake their own programmes of engagement which could inform regional differences between business plans. This will be legitimate in the eyes of their stakeholders by delivering on their desired outcomes and representing value to consumers.
- 2.1 Our members therefore welcome and are generally supportive of Ofgem's proposals for the distribution companies to set up a Customer Engagement Group with their focus being on ensuring that individual business plans are sufficiently tailored to and recognise the needs and preferences of local users and consumers. Likewise, they are supportive of the proposal for the transmission companies to set up a User Group who will provide input and challenge to business plans.
- 2.2 The introduction of a new independently chaired RII0-2 Challenge Group that will scrutinise business plans across all sectors and inform Ofgem's assessment of them is also welcomed. Whilst we support the rationale and objectives behind the setting up of these different groups, the detailed arrangements for their establishment and operation will need to ensure any associated risks are properly mitigated. Stakeholders have already highlighted the potential high level of resource required to support the groups and it is therefore important that the roles of the groups and how their output will be used by Ofgem is clear. For example, further clarity is needed on matters such as the panel member recruitment process, governance, Open Hearings, appeals process and other aspects.

Responding to changes in how networks are used

3. We welcome recognition by Ofgem of the contribution that our members are making towards facilitating the transition to smarter, flexible, low-carbon energy systems. We believe we are already making rapid progress through initiatives such as the ENA Open Networks Project² a major energy industry initiative that will transform the way our energy networks work, underpinning the delivery of the smart grid. Innovations and investment in gas networks are helping to build an energy system which will be lower cost and lower carbon in the long term, and by working together the networks will help build synergies across the gas and electricity networks providing a platform for future development and move to a 'whole systems' approach.
- 3.1 Whilst the overall direction of travel towards long-term sustainability is clear, we also recognise that there is uncertainty on the detailed pathway, which creates challenges for setting the next price controls. This uncertainty, could be significantly reduced by Government setting clearer policy direction. This is particularly the case for the future role of

¹ ENA response to RII0-2 Open Letter <http://www.energynetworks.org/assets/files/news/consultation-responses/ENA%20Response%20to%20RIIO2%20Open%20Letter%20Final%204%209%202017.pdf>

² ENA Open Networks Project <http://www.energynetworks.org/electricity/futures/open-networks-project/open-networks-project-overview/>

gas and a future whole systems approach that Ofgem recognise is needed to maximise value to consumers. Against the current background we recognise that the proposed approach to setting a price control length of five years as a default but with flexibility for networks to make a compelling case for some allowances to be set for longer periods strikes the right balance. However, final decisions by Ofgem on this question should only be taken once the results of companies' engagement with stakeholders on their business plans and the planned consumer user groups and challenge panels have been sufficiently engaged.

- 3.2 Above we have summarised our views on whole system outcomes, so recognise the need to ensure the price controls contain sufficient levers to support the approach. We also recognise there are pros and cons to bringing greater alignment of the sector price controls in support of this objective and greater alignment is to some extent presentational. Clarity is needed on roles and responsibilities across different sectors, including the processes for ensuring investment decisions are joined up and taken in a holistic way.
- 3.3 We agree it is important to ensure networks are efficiently utilised and appropriately invested in to meet current and future needs, but it is as equally important to ensure new investment needed is not delayed or deterred resulting in wider negative consequences for the delivery of government policy objectives and resultant benefits to consumers. There are a number of approaches and tools for mitigating any risk of asset stranding, these include the development of probabilistic scenarios, 'no-regrets' and 'ahead of need' investment methodologies and mechanisms such as re-openers and volume drivers. In considering the risks associated with potential asset stranding, it is important to balance this against the benefits of retaining optionality until the energy future is clearer. As previously highlighted, the setting of clearer policy direction, particularly in respect of gas would significantly mitigate any risk.
- 3.4 We are supportive of a separate electricity System Operator's (SO) price control from National Grid Electricity Transmission's (NGET's) Transmission Owner (TO) control.
- 3.5 We have previously set out our position in respect of the potential role network operators could play in encouraging end-use energy efficiency in our response³ to the recent BEIS consultation 'Building a market for energy efficiency; Call for Evidence'.

Driving innovation and efficiency

Driving Innovation

It is imperative that innovation in networks continues to be strongly incentivised under future prices controls, as the networks deliver their crucial role in developing the future energy system. The RIIO innovation stimulus has had significant success in encouraging network companies to bring forward innovative projects and embed a culture of innovation within their

³ ENA response to BEIS consultation 'Building a market for energy efficiency; Call for Evidence'
<http://www.energynetworks.org/assets/files/ENA%20Response%20to%20BEIS%20Call%20for%20Evidence%20Building%20a%20Market%20for%20Energy%20Efficiency%20Final%2009.01.2018.pdf>

organisations. This has led to significant advances in the application of new technologies and techniques and the development of skills and capability within the organisations involved, to the benefit of current and future consumers. Indeed a key feature of the RIIO-1 innovation mechanisms has been the collaboration and sharing of best practice delivering both short term benefits shared with the customers of the innovating network and subsequent longer term customer benefits across all networks. New approaches, including the development of whole systems incentives designed to drive innovation, used in combination with current type innovation support measures may also provide an attractive option, helping to deliver the energy system we will need in the future.

Since 2004, over 1,300 innovation projects have been delivered across both gas and electricity networks, allowing network operators to better understand how to integrate new energy technologies such as electric vehicles, renewable distributed generation and decarbonised sources of gas into our energy system. The projects reflect the purpose of Britain's energy network companies in building an efficient, smarter, cleaner energy system fit for Britain's homes and businesses. Independent research carried out by Pöyry has shown that existing innovation projects developed by electricity network operators alone under the Low Carbon Networks Fund could deliver up to £1.7bn of benefits by 2031.

Driven by decarbonisation, digitisation and decentralisation, network innovation projects are already helping energy network operators identify new ways of better serving their customers by developing quicker, more efficient and cheaper ways to deliver a cleaner energy system. Collaboration and transparency are key to ensuring network companies respond to the needs of their customers and continue to focus on priority areas for innovation, which can deliver most benefit to the wider energy system in the most effective way possible. Ofgem should ensure that RIIO-2 innovation builds on the progress in RIIO-1, including the gas and electricity Network Innovation Strategies⁴ which ENA has recently published.

The Gas Network Innovation Strategy sets out the role existing gas infrastructure can play in meeting demand for power, heat and transport in a low carbon economy. The approach is based on seven themes: the future of gas; safety and emergency; reliability and maintenance; repair; distribution mains replacement; environment and low carbon; and security. It should be noted that compared to the c.£1bn available funding to electricity networks under LCNF and NIC between 2010-2021 around c.£150m funding is available under RIIO-1 for gas networks. Delivering rapid progress in the decarbonisation of heat and transport as seen in the electricity sector is also possible if the right conditions are created under RIIO-2.

4. The electricity networks are undertaking a huge shift towards a smart grid, and network innovation will be critical to effectively delivering benefits in a collaborative and cost-effective way. The Electricity Network Innovation Strategy focuses on how current and future innovation projects can address the challenges and opportunities that will arise as we transition towards a smart, flexible energy system. This strategy is delivering this shift via five

⁴ **ENA Gas Network Innovation Strategy**

<http://www.energynetworks.org/assets/files/Gas%20Network%20Innovation%20Strategy%20Final%202018.pdf>

ENA Electricity Network Innovation Strategy

http://www.energynetworks.org/assets/files/electricity/futures/network_innovation/electricity_network_innovation_strategy/Energy%20Networks%20Association%20-20Electricity%20Network%20Innovation%20Strategy-March%202018.pdf

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themes: network improvements and system operability; transition to a low carbon future; new technologies and commercial evolution; customer and stakeholder focus; and safety, health and environment.

- 4.1 In respect of the specific proposals set out in the consultation document. We agree with the proposal to continue to provide an innovation stimulus where projects can demonstrate long-term value to consumers but are at higher risk of non-delivery under the core RIIO-2 framework. Retaining this element within the overall innovation stimulus package is essential if investment is to continue in higher risk and cost projects that incorporate technologies that are further from market, so have weaker commercial viability. This is also the case where immediate and longer-term benefits may not accrue directly to the network company delivering a project, but are spread more widely across networks and their users. Similarly, dedicated funding encourage cross-industry collaboration and there is a clear risk that other approaches would risk discouraging networks from working together with each other and wider industry partners. Experience shows the current regime is working well and is valued by stakeholders across the industry, who like us believe the basis of it should be retained.
- 4.2 We do not have strong views on the form of funding this could take, and are in-principle supportive of Ofgem's proposed approach of targeting support more towards critical issues associated with the energy transition and for it to be coordinated with other public-sector innovation schemes where in the interest of network consumers. However, clarity needs to be provided on what and how 'critical issues' are determined, for example, whether potential benefits in the form of carbon reduction, increased security, supply chain business development and associated costs etc are treated in this respect. There is also the question of how proposals will be considered under any evaluation and decision to support a project. We therefore suggest it may best be left to individual companies to decide what projects to take forward and for them to provide the necessary justification within a relatively broad framework set by Ofgem and taking into account the priorities set out in the joint network innovation strategies. In this respect we note the desire to co-ordinate funding with wider public-sector funding schemes which we acknowledge could bring benefits in the form of greater leverage of private sector investment and wider whole system perspectives. We recognise the potential benefits in enabling increased third party (non-network) engagement and participation in innovation projects, particularly in the context of delivering the transition to smarter flexible and whole system approaches, for example, the need for greater digitalisation. However, whilst in principle we are supportive, we are unclear of any additional benefit to consumers if third parties directly access funding, given that network companies need to be central to projects and are exposed to associated risks. We would also note that the networks already have a strong track record of working with third parties to deliver innovation, and disseminating learning from projects across the industry. Ofgem should share further evidence before making any policy decision.
- 4.3 Finally, whilst the networks already work closely with third parties including research institutions and other funding partners, other sources of funding for innovative projects and lower-TRL activity are not network-specific. Ofgem will therefore need to take care to ensure that the RIIO2 framework sufficiently supports the level of innovation that is needed to deliver the transformation required to our energy system. This is particularly clear in considering the direction of travel for bodies such as Innovate UK, who are moving away from sector-specific funding towards broader competitions.

Competition

5. As a principle, our members support considering new approaches that will deliver clear benefits to consumers. It is worth noting that network companies are already subject to EU procurement law and applicable financial thresholds over which projects are required to go to market under open tender. Where projects fall below the EU threshold competitive processes are also very likely to be used where transactions costs are not disproportionate and they can help to minimise costs due to the TOTEX incentives. Also much of the connections market in Gas and Electricity Distribution is already competitive.
- 5.1 For new projects, we caution against applying a simplistic read across of information from OFTO and interconnector regimes to wider gas and electricity networks. The key financial parameters on which any estimate of potential consumer benefits are assessed are very different, as offshore connections have distinct financial and regulatory characteristics compared to typical onshore investments. For example, in the case of offshore connections the assets are built and commissioned by the developer before a tender takes place, so an OFTO bears no construction risk at all. This means that an OFTO bidder does not need to make any allowance in its required cost of capital for construction risk or delay.
- 5.2 Any introduction of new competitive models across networks needs to be considered carefully given the physical and operational characteristics of our networks and the technical, commercial, regulatory and legal requirements that must be met by those that own and operate them. Ahead of competition being extended to new areas a robust cost benefit analysis should be developed and consulted upon to ensure there is a strong evidence based consumer case relative to a realistic counterfactual.

Simplifying the price controls

6. As a principle our members support the increased use of outputs and incentives as a way to drive and measure company performance. The aforementioned consumer panels would be expected to have a role in the process of setting these.
- 6.1 We support the principle that companies which deliver additional value to consumers through better performance should be recognised and rewarded. However, the resetting of targets within a price control period has the potential to undermine the business case for investment and will increase investment risk, particularly in higher risk longer-term innovations. This is likely to drive a focus on short term quick pay back incremental type investments. It is therefore difficult to see how these risks and downsides would be outweighed by any consumer benefits derived from the re-setting of targets over the proposed and relatively short 5-year price control period and against a long-term outlook.
- 6.2 Our members are generally supportive of the overall approach of setting up front baseline costs allowances together with the use of uncertainty mechanisms. The setting of up front ex-ante type baseline cost allowances together with associated clear outputs is a proven simple, clear and stable approach for delivering efficiencies, improved performance and consumer benefits. The current sector price controls will provide Ofgem with extensive data on network companies' actual costs and performance that can be used to benchmark costs set out in future business plans and to appropriately calibrate and set uncertainty and incentive mechanisms. Whilst we recognise that there are benefits in using uncertainty

mechanism for some aspects of the price control these should be constrained to those areas where there is a significant degree of uncertainty over costs and/or the nature of any future developments.

RPE indexation

- 6.3 The use of RPE indexation may be appropriate and has the potential to help manage uncertainty and associated risk for both consumers and companies. However, for it to be effective it is essential the index used is relevant and robust. This is an area which will need further work and should include how to address the fact benchmarking will never be fully reflective of the actual costs incurred and the nature of network businesses and the types of cost variance to which they are exposed.
- 6.4 It is difficult to envisage how the resetting of costs based on actual cost performance during a price control period would work. Whilst the provision of actual costs data to Ofgem will assist in bringing greater transparency and benchmarking it is difficult to see how costs could be normalised between companies to account for one-off or distorting factors. Again, this type of approach could play negatively in terms of networks working collaboratively and sharing information and weaken incentives to innovate and find efficiencies.

IQI

- 6.5 When considering the extent to which the IQI mechanism incentivised the desired behaviours under RIIO-1 it is important recognise that IQI was established very late in the GD-1 process, after initial business plans had been submitted. It is not the case that companies inflated their forecast costs in RIIO-1 when Ofgem's analysis shows that DNOs could have achieved significantly higher revenues had their forecasts more accurately reflected the actual costs incurred. This would seem to suggest that as designed the IQI is an effective mechanism but that it was poorly implemented.

Fast tracking

- 6.6 It is important that Ofgem continues to recognise the benefits to consumers that flow from incentives that Ofgem puts in place for companies to bring forward efficient plans at the price control review. Fast tracking was one of Ofgem's tools for achieving this. If Ofgem does withdraw or modify it in any sectors, it is important that Ofgem considers carefully how to ensure the original policy objectives of fast-tracking are still met.

Annual reports

- 6.7 We believe Ofgem should undertake a review of reporting requirements in terms of what aspects of the network's business is being reported against and the level of detail required. Part of this assessment should be whether, and how, the reported information is being utilised, or if it is in any way needed at all, and whether there is scope for simplification, rationalisation or re-prioritisation. Any duplication of reporting requirements should be identified and removed. We would recommend Ofgem work with network companies and stakeholders to take the recommended initiative forward.

Fair returns and financeability

7. Below we set out a number of observations on this section of the consultation and a number of the issues raised.

- 7.1 As a general observation we reiterate our 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 that there is scope for making refinements to the RIIO framework. However, we 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.

Cost of debt

- 7.2 Energy networks have, over many years, issued debt in order to maintain low financing costs for consumers, as recognised in successive Ofgem price control settlements. They have also issued long term fixed rate debt, limiting the risk exposure of consumers to financial market fluctuations.
- 7.3 Whatever approach is taken on the cost of debt, it is important that Ofgem recognises the long term nature of debt issuance by energy networks. Some commentators have made opportunistic claims that debt allowances could be based on debt costs incurred in the last five years only. Not only are claims like this misleading and therefore unhelpful to consumers, since they imply company costs are lower than they actually are, they heighten investor risks through the un-informed political and regulatory dialogue they promote.
- 7.4 Overall Ofgem must ensure it recognises longer term debt financing. Any other approach would be highly detrimental to investor certainty and so would raise financing costs to consumers.

Cost of equity

- 7.5 In order to help inform the evidence base ENA commissioned independent consultants Oxera to provide an analysis of the most appropriate methodology for calculating the cost of equity and applying that methodology, the indicative level it would be set under market conditions. In addition, building on this earlier work Oxera carried out a review of Ofgem's key assumptions for the cost of equity set out in this consultation. A copy of both reports '*The Cost of Equity for RIIO2*'⁵ and '*Review of Ofgem's Initial Cost of Equity for RIIO-2*'⁶ are included as part of this submission.
- 7.6 Our members broadly concur with the findings and conclusions of the Oxera work. These include that:

- The structure of the methodology for estimating the cost of equity under RIIO-1 still represents the best means of doing so and should be used for the RIIO-2 process.

⁵ 'The Cost of Equity for RIIO-2', Oxera 2018

http://www.energynetworks.org/assets/files/info/Oxera%20research%20on%20the%20cost%20of%20equity_2018-02-28.pdf.

⁶ '-Review of Ofgem's Initial Cost of Equity for RIIO-2', Oxera 2018

[http://www.energynetworks.org/assets/files/Review%20of%20Ofgem's%20initial%20proposals_Final%20\(010518\).pdf](http://www.energynetworks.org/assets/files/Review%20of%20Ofgem's%20initial%20proposals_Final%20(010518).pdf)

- When comparing the risk of energy networks to other sectors such as water, there may be an increase in fundamental risk differences between water and energy networks over the RIIO-2 period.
- As there are limited data points for energy network betas in the UK, water networks may not be representative of the systematic risk exposure of energy networks over the RIIO-2 period.
- Energy networks over the forthcoming RIIO-2 price control will be accommodating a period of potentially rapid technological change, which will create uncertainty around patterns of expenditure for network reconfiguration.
- It is unlikely that exposure to such risks can be fully mitigated through regulatory mechanisms (e.g. indexation, pass-through, volume drivers, re-openers, etc.). The residual risk will be borne by equity investors.
- Limiting the change in the allowed return on equity for the RIIO-2 controls compared with the RIIO-1 controls would support long-term investment decisions.

The research recommends a range of 5.51–6.34% to inform the assumption for the real (RPI-deflated) cost of equity in RIIO-2.

Indexation of equity

- 7.7 On the question of indexation of equity the Oxera work found that the cost of equity is not observable. Therefore, in any attempt to index the cost of equity, a decision needs to be taken about whether (and how) to index one, or several, of the cost of equity parameters. The design of any cost of equity indexation mechanism will involve a higher degree of subjectivity than the equivalent mechanism for the cost of debt.
- 7.8 The Oxera work also identified a number of evidenced principles for indexing the cost of equity:
- there is a negative correlation between the Equity Risk Premium (ERP) and the Risk Free Rate (RFR), which implies that indexation of only the RFR would create large errors;
 - the Total Market Return(TMR) is relatively stable over time, which implies that the TMR generated by the indexation mechanism should be relatively stable over time;
 - equity beta estimates are more volatile over time than would be expected given the relatively stable risk characteristics of the businesses. This implies that the beta parameters of the indexation mechanism should be more stable than the market estimates, or should be fixed.
- 7.9 Overall, a move to cost of equity indexation would represent a considerable change in methodology. Such a change in methodology would need to fully take into account the principles above, be appropriately signalled and introduced with appropriate transitional arrangements such that it does not undermine investor confidence.

Ensuring fair returns

- 7.10 We also ask Ofgem to consider carefully whether adopting any of 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 also 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.

- 7.11 At time of writing work is underway, commissioned by ENA, that considers the five ‘failsafe’ measures set out under this section of the consultation. The output from this work will provide a useful contribution to the evidence base and assist Ofgem in its consideration of this aspect of the RIIO framework. ENA will share this work with Ofgem when completed.

Conclusions

8. ENA on behalf of its members welcomes the opportunity to respond to this consultation on the future framework for RIIO-2. We reiterate our points regarding the success of RIIO-1, the experience and knowledge that is being gained in its application which supports evolutionary refinements to the existing RIIO ‘tool kit’ as the best way to deliver the right outcomes for consumers.
- 8.2 We strongly support Ofgem in seeking to set a framework that delivers a ‘fair deal’ for both consumers and investors. This means creating the conditions to attract new investment and drive behaviours that deliver network services that meet the needs and wants of a wide range of consumers consistent with advancing the UK’s wider clean growth energy policy. We therefore caution against overly focusing on capping returns to investors regardless of levels of performance as this risks eroding incentives to invest, innovate and improve performance for customers.
- 8.3 RIIO-2 needs to enable the energy sector to meet the future challenges of an uncertain investment and growth future, setting stretching targets whilst providing a stable regulatory regime in which investors can have confidence. This needs a holistic approach driven by objectivity and evidence.
- 8.4 Finally, we would like to acknowledge the stakeholder engagement activities that Ofgem has undertaken since publication of its RIIO-2 Open Letter last year. On behalf of our members we look forward to continued engagement with Ofgem over the coming months and beyond as we move into the sector specific price controls.

If you have any questions on the points raised in this response, please contact John Spurgeon, Head of Regulatory Policy, Energy Networks Association email: john.spurgeon@energynetworks.org

Energy Networks Association

2 May 2018