UK Power Networks
Delivering your electricity

Office of the Chief Executive

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By email only to RIIO2@ofgem.gov.uk

Dear Akshay

RIIO-2 Sector Specific Methodology Consultation

Thank you for the opportunity to give feedback on the above consultation. Our response should be treated as consolidated on behalf of UK Power Networks' three distribution licence holding companies: Eastern Power Networks plc, London Power Networks plc, and South Eastern Power Networks plc.

The latest Committee on Climate Change's annual progress report[1] stated that 75% of emission reductions in the UK have come from the power sector since 2012. We are proud to have been a key enabler to this progress by connecting over 6GW of renewable generation to our networks in such a short time period. In addition to enabling low cost connections, our attention is also now firmly on supporting the development of well-functioning flexibility markets, as well as facilitating Electric Vehicles (EVs). EVs are connecting across our network faster than anywhere else in the UK with over 60,000 vehicles (approximately 30% of the UK total) already charging within our networks today. We agree with Ofgem that the distribution networks will be at the heart of enabling the energy transition. The evolution of RIIO must provide an environment that attracts the huge amount of investment, talent and innovation needed to enable network companies to support the UK to meet its challenging carbon reduction targets and be a world leader in low carbon technologies.

The RIIO regulatory framework represents a major step forward in the way electricity and gas networks are regulated, which is internationally recognised based on the significant performance improvements that are being realised compared to other markets. In electricity distribution, the average number of customer interruptions has fallen by 11% and the duration of interruptions has reduced by 9% in just the first three years of RIIO-ED1[2]. At the same time industry average customer satisfaction scores have improved; all whilst reducing the electricity distribution element of consumer bills by 19%. Underpinning this progress is the shift from input based regulation, which focussed on capital expenditure, towards strong incentive based regulation that re-focusses companies' attention on using innovation and a full suite of options to deliver outcomes that are important for customers at the lowest cost.

[1] https://www.theccc.org.uk/wp-content/uploads/2018/06/CCC-2018-Progress-Report-to-Parliament.pdf

[2] https://www.ofgem.gov.uk/system/files/docs/2019/03/riio-ed1_annual_report_2017-18.pdf

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For example, the RIIO framework has supported UK Power Networks to be one of the first network companies in the world to open up all of our load related reinforcement requirements to the market – as business as usual, not just a pilot or trial. If a market based flexibility provider helps us to deliver the same output for less money we will procure it. We are also preparing our networks for the future by investing over £80 million in state of the art monitoring and control systems. This will target 6,000 of our 100,000 sites across our networks to be able to identify and target flexibility needs or reinforcement investment where it is needed. This is only the start. We expect to build on the learning from this programme to provide well- justified investment proposals in RIIO-2 that further smarten and modernise our networks to meet the changing needs of the communities that we serve.

RIIO has incentivised companies to innovate to deliver the outputs that customers value whilst minimising expenditure and hence the cost to them, in effect replicating the dynamics of a competitive market. For RIIO-2, Ofgem has proposed new mechanisms, such as the blended sharing factor and a Return Adjustment Mechanism (RAM). Whilst we understand Ofgem's intentions, it is vital that these proposals do not weaken the overarching incentive for companies to innovate, find efficiencies and develop new services to meet the needs of consumers in a fast changing energy market. This is particularly pertinent for electricity distribution, which will be at the forefront of the significant changes facing the energy and transport sectors in the coming years.

With this in mind, we have summarised below our suggestions of how Ofgem can deliver its desired outcomes as part of an overall regulatory framework that is simpler, more transparent and continues to replicate the dynamics of a competitive market.

Giving consumers a stronger voice

- **Define what a good business plan looks like by issuing clear guidance on the assessment criteria and associated weighting similar to a competitive market tender process**
  Greater stakeholder engagement during the business plan stage will naturally create expectations about what is delivered. Our observation of Ofwat's PR19 assessment of business plans is that, in numerous cases, enhancement projects co-developed by stakeholders and their water company were ultimately rejected as part of Ofwat's assessment phase. Whilst there may be valid reasons for this, from a stakeholder perspective there is a risk that this undermines the engagement process. To avoid this happening in RIIO-2, we request that Ofgem clearly defines upfront and communicates to network companies and their stakeholders, the criteria and weightings it will use as part of its assessment process.
- **Enhance the Stakeholder Engagement and Customer Vulnerability (SECV) mechanism by introducing a penalty element alongside a financial incentive**
  One of the major strengths of the current RIIO framework has been the emphasis placed on protecting consumers in vulnerable circumstances. Building on what has become embedded in RIIO-ED1, we see merit in establishing the vulnerability element as its own standalone mechanism. Rather than removing the financial element of the incentive as part of a stakeholder engagement incentive in RIIO-ED2, Ofgem should consider introducing a symmetrical incentive to appropriately sharpen this mechanism.
- **Build on the now embedded stakeholder engagement practices in RIIO-1, through the use of Customer Engagement Groups**
  Regular and high-quality stakeholder engagement is deeply embedded in our business. It enables us to continuously improve our services, ensuring that we meet the changing needs of customers and the wider communities that we serve. We are particularly encouraged by Ofgem's commitment to assess business plans based on how well they reflect stakeholders' input. We support the development of Consumer Engagement Groups as another positive development of the RIIO framework.

Reflecting what consumers want and value from networks

- **Strengthen incentives, such as for reliability and service, that meet common objectives by including annual dynamic targets based on benchmarked revealed performance**
  We are broadly supportive of introducing well designed dynamic incentive targets which ensure that targets are sufficiently challenging such that good performance is appropriately rewarded. The dynamic target resetting methodology must be clearly set out upfront and enshrined in the licence for RIIO-2. It must allow for targets to move both up and down based on revealed benchmarked performance.
- **Provide freedom for companies to co-develop bespoke incentives with their stakeholders that address their local needs**
  Wherever feasible, incentives should be developed to benefit all GB customers and provide simple comparators of performance across different companies. However, where local needs indicate a requirement for a differentiated service offering, we agree that companies should have the freedom to develop bespoke outputs and incentives.
- **Set any minimum standards at a level deemed acceptable by customers and supplement these with symmetrical rewards and penalties based on enhanced performance targets**
  In principle, we agree with Ofgem's intentions for the use of licence obligations, price control deliverables and output delivery incentives. A clearly defined licence obligation should set a minimum standard at a level deemed acceptable by customers and deliverable by companies. Ex-ante allowances must fund the efficient delivery of these minimum standards. Enhanced performance targets could be set for higher levels of performance, with a symmetrical reward and penalty mechanism.

Enabling whole system solutions

- **Set a single totex sharing factor in RIIO-2 to ensure a level playing field between different network companies that can deliver the same output**
  As the opportunity for cross-sector collaboration increases, we believe the simplest way of enabling whole system benefits is for Ofgem to apply a single, common, totex sharing factor to all network companies. The Totex Incentive Mechanism (TIM), alongside a suitable sharing factor, should focus on rewarding or penalising company performance within the price control, whereas Ofgem's proposed business plan incentive should be the only mechanism to determine the reward/penalty of cost efficiency. This would provide a level playing field between companies that can potentially deliver the same output for customers and would allow Ofgem to focus on designing any RAM to ensure returns are fair. It also avoids any need for further complexity through additional mechanisms such as the "Coordination and Information" incentive and a blended sharing factor, and further challenges of interaction and compatibility with other areas within the price control. We recognise that the move to a single, consistent sharing factor across sectors is a significant departure from previous controls, however, we welcome the opportunity to discuss how we believe this can work in a coherent package and deliver the outcomes that Ofgem desires.
- **Support coordinated cross-sector reopeners to ensure that outputs and associated funding can be transferred to the most efficient delivery body**
  It is increasingly recognised that smarter distribution networks will be central to facilitating the energy transition and ensuring that associated benefits flow back to customers, and particularly to those that are willing to provide flexibility. For example, there will be cases where we can deploy smart solutions (such as demand side response) alongside a new cluster of EVs, which simultaneously resolves both transmission and distribution constraints. To facilitate this, we support Ofgem's proposal for the development of cross-sector reopeners in RIIO-2 that enable outputs and associated allowances to transfer to the party that is best placed to deliver them.

- **Improve the Directly Remunerated Service (DRS) funding mechanism to ensure that companies have a risk and reward profile commensurate with the benefit they are providing to consumers**
  Our experience of RIIO-1 is that the DRS mechanism works at a basic level; however, in its current form, we do not think it truly drives whole system benefits. One of its key limitations is that the allowed margin for the party delivering a solution is minimal compared to the incentive on output delivery. DRS routes should be revised to ensure companies have a risk and reward profile commensurate with the benefit they are providing to customers.

Ensuring future resilience

- **Evolve the current RIIO-ED1 methodology on network outputs to improve how companies assess longer term risks**
  We recognise Ofgem's desire to enhance its methodology of assessing network risk to reflect the life-time benefit of interventions. Before deciding to introduce a new Network Asset Risk Metric (NARM) for RIIO-2 that risks being rushed and incomplete, we believe that Ofgem should work with the industry to adapt the existing RIIO-ED1 Common Network Asset Indices Methodology (CNAIM). This provides a strong foundation to build upon and refinements could be in place for the start of RIIO-ED2.

  Furthermore, any new metric should not be the primary basis for justification of companies' investment proposals for their asset management activities; instead, this should remain with the company's asset management teams who are best placed to manage short and long term risks on behalf of their customers using all available evidence.

- **Support the development of a workforce that has the skills to deliver the energy transition, reflecting the communities they serve**
  Many utilities are facing significant challenges, both in replacing and recruiting a workforce fit for the future. This is particularly apparent in electricity distribution, where millions of new small generators and connected devices are revolutionising the way we manage our networks. Companies should therefore be supported through their allowances to ensure they have a workforce with the right skills and that they reflect the communities they serve. A series of surveys of companies' workforce strategies could then be undertaken to ultimately inform whether it is necessary to design and introduce any metrics in these areas for RIIO-2.

- **Fund cyber resilience activities via suitable ex-ante allowances with appropriate outputs. This ensures that efficient delivery is incentivised**
  As we move to a more decentralised and digital energy system, most industry observers expect the number of connected smart devices to rise exponentially. Whilst providing huge opportunities for new services for consumers, they also represent new attack surfaces that could be used to disrupt electricity supplies. Electricity companies must continue to be appropriately funded to combat fast evolving threats through ex-ante allowances, ensuring security is delivered whilst costs are kept down for customers.

Managing uncertainty

- **Align all network price controls in RIIO-3 and enhance flexibility in RIIO-2 by appropriate use of volume drivers alongside uncertainty mechanisms**
  Ofgem's move to shorter price controls in RIIO-2 will significantly help with managing uncertainty and reduce the risk of forecasting errors. We recommend that Ofgem aligns all of its network price controls for RIIO-3, either by shortening RIIO-ED2 to three years or by extending the price controls starting in 2021 by two years. We believe this will facilitate whole system approaches and increase efficiency, because it will enable business plans to be coordinated across sectors, avoiding stakeholder fatigue and ensuring the right delivery body for network solutions from the outset.

Alongside this we continue to support the use of new volume drivers and uncertainty mechanisms as a way of ensuring companies are able to flexibly deal with uncertainty during RIIO-2 for the benefit of their customers. For example, in RIIO-ED1, we already have separate reopeners for load related expenditure and high value projects, which protect both network companies and customers from the level of required investment being materially different from the original forecast.

Lastly, to ensure that all RIIO-ED1 data is utilised as part of Ofgem's cost assessment in RIIO-ED2, any difference between forecast and actual spend in the last two years of RIIO-ED1 should be accounted for as part of an adjustment in RIIO-ED2.

- **Include anticipatory investment as totex spend and not a standalone investment and encourage efficiency improvements by developing a utilisation metric in RIIO-ED2**
  We support network companies taking a stronger role in addressing societal issues; particularly in areas such as climate change, as we will need to ensure that our network is resilient to evolving challenges. For example, we are working closely with the Greater London Authority to ensure our network can facilitate a switch to cleaner, electric, forms of transport in London. Therefore, we agree with Ofgem that network companies should be encouraged to support these types of developments in their business plans as long as they are well justified. If, at the time of the business plan submission, a larger investment need is identified and well justified, we believe this should be considered as part of totex, within a High Value Project (HVP) mechanism. This enables simplicity, clarity and visibility for Ofgem, network companies and stakeholders to assess cost submissions. For any larger investment that is identified in-period, this should be dealt with through an HVP reopener. We do not believe there is a case for treating any well-justified 'anticipatory' investment differently from other spend, and our concern is that this will drive the wrong type of behaviour. To ensure investments are and continue to be justified, we believe there is merit in developing a new utilisation incentive in RIIO-ED2. This could sharpen the incentive on DNOs to use innovative solutions in local areas to improve network efficiency.
- **Mitigate forecasting errors through the use of indexation where suitable**
  We believe the indexation of Real Price Effects (RPEs) will help to mitigate forecasting errors, in line with what we advocated prior to the start of RIIO-ED1.

  On cost of equity indexation, we recommend further analysis of the impact on revenue volatility, both for network companies and market participants, before this is implemented. Further explanation is provided in our answer to question FQ5.

Driving innovation and efficiency through competition

- **Maintain the Totex Incentive Mechanism (TIM) with a suitable sharing factor to drive innovation and competition as business as usual**
  We recommend that Ofgem continues to use the totex approach in RIIO-ED2 to stimulate nascent local flexibility markets, whilst ensuring distribution network companies remain accountable for service delivery when contracting and deploying any market based solution. Whilst a margin or fee approach to running competitions may work in a mature market with established players, we think this approach is unsuited to stimulating new markets where there is uncertainty about deliverability and costs.

  A key benefit of the DNO to DSO transition is that it ensures that security of supply will not be compromised at the same time as facilitating the energy transition. For example, network companies have clear accountability for meeting engineering standards that deliver high service levels; this is then reflected when contracting and deploying non-network solutions.
- **Simplify innovation by removing the Network Innovation Allowance**
  We agree with Ofgem that innovation should continue to be deployed as part of network companies' business practices. The TIM, coupled with an effective sharing factor, is the best way of achieving this as opposed to providing innovation funding and then applying arbitrary "smart grid" savings with no real basis.

Whilst the NIA has provided an important stimulus for smaller companies to develop innovative products and services in RIIO-1, as the market is now more mature there is merit in considering whether the NIA could become business-as-usual. We therefore recommend that Ofgem simplifies RIIO-2 by removing the NIA and providing companies with an efficient level of totex coupled with strong incentives to innovate in order to outperform for the benefit of customers.

- **Promote competition where it can demonstrably provide the greatest benefit to customers**
  As a principle, we support Ofgem's use of competition to drive cost efficiencies wherever it can demonstrably benefit customers. Since the start of RIIO-ED1 there has been a significant increase in competition for new connections. For single, high value projects, Ofgem has understandably been looking at the role of what it defines as 'early' competition as a way of ensuring price discovery; however, until this has been shown to consistently work well we do not see a case for exploring its use for highly integrated, high volume, low cost works where the majority of the work on our networks lie. The Department of Transport's 'Strategic Vision for Rail'[3] recognises the difficulty in contracting high-volumes of works and that it can result in poor performance for the customer when *"things go wrong, energy and time which could be spent on solving the problem can be lost in contractual debate and industry dispute processes."* We are concerned that forcing competition into areas where it is not suitable is an outdated model which will be to the detriment of customers and be guilty of not learning the lessons of the past.

  Importantly, the TIM already drives network companies towards native competition that delivers cost savings, which are then shared with consumers via the sharing factor. We strongly believe that totex incentives provide the right risk and reward balance by encouraging network companies to deliver their outputs at lowest cost.

Simplifying Business Plan assessment

- **Drive the right behaviour by introducing a competed pot in the business plan assessment, and ensuring that the size of the pot provides a strong and meaningful incentive signal to companies**
  The inclusion of a strong symmetrical financial reward and penalty on network companies' business plans, has the potential to drive stakeholder engagement and early buy-in to the RIIO-2 process. The business plan incentive should be the sole mechanism to incentivise ambitious plans and ensure efficient costs. This negates the need for either an IQI or a blended sharing factor to adjust the TIM. To achieve this, Ofgem should use clearly defined quantitative and qualitative elements in its assessment, as this will help companies to deliver high quality business plans backed by their stakeholders. Including a competed reward pot, proportionally sized to the number of companies within that sector, provides Ofgem with the opportunity to replicate the competitive dynamic that would exist in the wider market.
- **Ensure companies are held accountable for delivering their plans by including business plan rewards and penalties within any Return Adjustment Mechanism (RAM)**
  If Ofgem continues with its plans to introduce a RAM in RIIO-2, we believe it is crucial that any reward/penalty from the business plan incentive is included within the RAM envelope. Failure to do so presents a danger that customers may inadvertently pay for a "good sounding plan" regardless of whether a company has the ability to deliver it because Ofgem would have no scope to claw back the reward. Whilst Ofgem may attempt to close this loophole with specific commitments from the network company, we believe a simpler and more transparent outcome would be to build all business plan outcomes into any RAM.

[3] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/663124/rail-vision-web.pdf

- **Ensure cost assessment is fair and comparable through regional adjustments that are not necessarily a zero sum game**

  It is not appropriate for all regional cost adjustments to be considered symmetrical. Whilst it can work for certain cost elements (e.g. regional wage differentials), it is not appropriate for elements that are inherent within particular networks, such as increased costs resulting from the Ultra Low Emissions Zone in London or the need for remote location generation in parts of the Scottish Highlands. Fair and appropriate cost assessment must be considered at an individual licensee level, taking account of robust evidence cases and the regulatory precedent developed by Ofgem over successive price controls.

Fair Returns and Financeability

- **Revise the cost of equity in RIIO-ED2 to correct methodological errors to ensure it incentivises investment in a way that really drives the energy transition**
  It is important to remember that the cost of equity is the incentive to invest and if Ofgem sets a cost of equity below a fair level, it risks setting an investor perception that incremental investment destroys value. Furthermore, we do not agree with Ofgem's proposal to adjust the derived cost of equity by its view of expected outperformance. Instead, regulatory targets should be set appropriately to incentivise companies to innovate and deliver the outputs that customers want, at the lowest cost.
- **Ensure the appeals process supports the overarching regulatory framework**
  We have concerns around the wording in the consultation that seemingly presents Ofgem with the option to open up all areas of a price-control settlement following a successful challenge through the Competition and Markets Authority (CMA). As a principle, we do not believe it should be within Ofgem's powers to retrospectively alter other areas of the price control, as this could lead to adjustments that do not fulfil the intent of a CMA ruling and provide significant uncertainty to companies and their investors. Further work and detailed explanation is needed from Ofgem on this topic to ensure all parties perceive the entire process provides certainty and fairness.
- **Design any Return Adjustment Mechanism with the aim of:**
  - **Being simple to implement and transparent to stakeholders**
  - **Avoiding a situation whereby poor performers dilute the returns of better performing companies**
  - **Mimicking a competitive market by retaining an incentive to deliver frontier performance**

  We believe that Ofgem can ensure fair returns by setting appropriate targets and allowances. If a RAM is to be introduced, it should be designed with the characteristics defined above and must only operate in extreme scenarios in order to avoid blunting the incentives in RIIO-2. Of the options presented by Ofgem, our current view is that 'proportional anchoring' best meets Ofgem's desired outcomes in the distribution sectors whilst having the least distortionary impact. We do not agree with Ofgem's proposal to avoid adjusting companies relative to the base cost of equity, as this could mean that a strong performing company and its customers are subsidising another company's poor performance. Instead, all companies should be adjusted if a RAM threshold is breached.
- **Any RAM introduced should only include companies' performance that management can materially affect**
  A RAM should only operate on parameters that are controllable by a company's management team – these should include the level of totex spend and performance against incentives, e.g. bespoke incentives and the business plan incentive. Financial out- or under-performance should not be within scope; for example, the ability for a company to materially affect its performance against its historical debt portfolio is limited and risks arbitrarily creating winners and losers.

Achieving a reasonable balance in RIIO-2

- **The RIIO-2 package should provide certainty and fair rewards for companies to invest efficiently to deliver the necessary customer outputs and support the delivery of a low carbon economy**
  Ofgem should retain the focus on the TIM as the main driver for companies to cost efficiently deliver excellent performance. This should be enabled by setting a single sharing factor (within a range of 40-60%) and use the business plan incentive for cost assessment to ensure efficient business plans, rather than introducing blended sharing factors that will add significant complexity for little value. A key benefit of the totex model in RIIO was to remove any bias between capital and operating expenditure. To reduce total costs for our customers, we are incentivised to test and deploy innovative non-network options, such as demand side response, whilst ensuring we deliver excellent levels of performance for our customers.

Conclusion

We fully support Ofgem's continued use of the RIIO model in the next round of gas and electricity network price controls. The proposals that we have set out above will support the design of an overall price control package that protects customers, delivers efficiencies and enables companies to be financeable and appropriately rewarded. It will also ensure that the UK regulatory model continues to be at the forefront internationally and a leading example of how to facilitate a low carbon future.

We are committed to working with Ofgem over the coming months to ensure that the new proposals under RIIO-2 are well designed and fit together as an overall coherent price control package.

Our responses to the relevant questions from your consultation are set out in the appendices to this letter. We hope that you will find our comments helpful and if you wish to discuss any part of our response, please do not hesitate to contact us. We look forward to working with you over the coming months to develop the suggestions in this response, and to set up a clear process for RIIO-2 and subsequently RIIO-ED2.

Yours sincerely

Basil Scarsella
Chief Executive Officer
UK Power Networks