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Dear Colleagues,

I am responding on behalf of the Scottish Government to Ofgem's RIIO-2 Sector Specific Methodology consultation, issued on 18th December 2018.

The Scottish Energy Strategy (our Strategy) sets out our vision for the future energy system in Scotland.¹ It articulates a vision built around our priorities, many of which are in line with wider Ofgem priorities, and in tune with the wider direction of travel across the UK. Scotland's energy networks will play a vital part in delivering our Strategy, and the transition towards a low carbon future. It is crucial that they develop and are funded in a way that recognises the key role they play in the energy transition and delivering a sustainable, low carbon future which supports our ambitions, allowing us to deliver on our commitments to Scotland and support the decarbonisation of the energy system across Great Britain.

Our Vision for Scotland's Electricity and Gas Networks,² published earlier this week, sets out in detail how we think our energy networks need to develop, in a way which is consistent with the priorities in our Energy Strategy. In particular, it sets out our desire for:

- **A secure and resilient electricity transmission network**, with a system operator that is able to access the technical 'ancillary' service needed to maintain stability and operation of the wider electricity system, and **new electricity transmission infrastructure that ensures we can meet our renewable energy ambitions.**
- **A gas transmission system** which continues to safely and efficiently transport gas across Scotland and Britain, **providing vital storage and**

¹ The Scottish Energy Strategy, Scottish Government, December 2017. Available here: <https://www.gov.scot/Publications/2017/12/5661/downloads>.

² A vision for Scotland's electricity and gas network, Scottish Government, March 2019. Available here: <https://www.gov.scot/binaries/content/documents/govscot/publications/publication/2019/03/vision-scotlands-electricity-gas-networks-2030/documents/vision-scotlands-electricity-gas-networks-detail-2019-2030/vision-scotlands-electricity-gas-networks-detail-2019-2030/govscot%3Adocument>

flexibility to our energy system, and through which **opportunities to support decarbonisation of gas** that flows through the network can be realised.

- **Gas distribution network companies** that assess and **make investment decisions based on their carbon, economic and social benefits**. This includes considering their potential to reduce fuel poverty, and opportunities to connect low carbon sources of gas, particularly where these can be linked to consumers through local and community energy projects and lead to more efficient use of the network.

We also set out our desire for a much better understanding of how to balance the interests of today's consumers against those at different points in the future; it is critical that Ofgem balances the need to deliver value for money for current consumers with ensuring sustainability for future consumers.

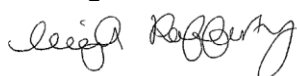
Our Networks Vision highlights the increasingly important role which "anticipatory" investment is likely to play – i.e. circumstances or areas where the need for spend and upgrades to accommodate an expected surge in demand is seen as the best way to mitigate related risks. The approach to this issue will be an increasingly important part of this and future price controls, and require careful co-ordination and collaboration between the regulator, stakeholders and government.

We understand that Government – national, devolved and local – has an important role to play in reducing the uncertainty over the future of the energy system. We are keen to continue to develop an effective and constructive relationship between Ofgem and government at all levels. An important part of our vision is for Ofgem to be able to consider Scottish policies, programmes and priorities when making its decisions. We set out some relevant Scottish policy, targets and priorities in annex 1.

We remain very interested in the development of RIIO-2, and, in general, the network regulation, investment and innovation needed to support the energy transition, and look forward to remaining engaged with Ofgem as these processes and debates continue. We set out some general points of feedback in response to Ofgem's proposals for RIIO-2 in annex 2. Our response:

- Reflects discussions and feedback from a range of key stakeholders;
- Underlines the need to balance reductions in cost and better value for consumers with delivering vital investments where needed;
- Supports current and continuing efforts to engage with and meaningfully involve stakeholders and consumers in this process; and
- Highlights the key role of incentives and innovation in delivering improvements and responding to rapid changes across the sector.

Kind regards,



Leigh Rafferty

Head of Electricity Markets and Regulation Policy

ANNEX 1 – SCOTTISH POLICY FRAMEWORK, TARGETS AND PRIORITIES

There are substantial energy policy areas devolved to the Scottish Parliament – particularly around heat and energy efficiency. We expect all energy network owners and operators to fully consider Scottish Government policy in these areas when developing business plans and setting price controls.

In addition to our devolved powers, there are a number of other differences in terms of our ambitions, targets and priorities compared to the UK Government. We expect Ofgem to provide sufficient flexibility in the network price control framework to reflect devolved competence and these differing levels of ambition in relation to decarbonisation, and to fully take this in to account when assessing the business plans of network companies operating in Scotland.

We set out the Scottish policy framework for areas of devolved responsibility, and the Scottish Government’s distinct targets and priorities, below.

Scottish policy framework

Energy Efficient Scotland

Energy Efficient Scotland (EES) is a 20 year strategy to increase the efficiency of the building stock in Scotland. The First Minister launched the Energy Efficient Scotland Route Map in May 2018³ and we expect the programme to require around £10 to £12 billion of investment from public and private sources over the lifetime of the project.

Improving the energy efficiency of our building stock will clearly impact on future energy demand. Network companies need to ensure that the business plans they develop reflect the impact that this substantial focus and investment on energy efficiency will deliver in Scotland. It is important that SGN, as the Gas Distribution Network (GDN) owner in Scotland, coordinates closely with the schemes through which we expect to deliver our EES when carrying out its work on the Fuel Poor Network Extension Scheme (FPNES) and other work to support vulnerable customers.

Local Heat and Energy Efficiency Strategies

Local Heat and Energy Efficiency Strategies (LHEES) is a central mechanism to deliver EES, and our ambitions for low carbon heat. Local authorities will be asked to develop LHEES laying out the most appropriate way to deliver efficiency and low carbon heat in their area. Our ambition is for each local authority to produce a LHEES alongside their local and strategic development plans.

At present the majority of local authorities in Scotland are undertaking pilot projects. The way in which LHEES will be delivered will depend on legislation which we plan to introduce to the Scottish Parliament once sufficient learning has been developed from the trials. We expect the network companies to:

³ <https://www.gov.scot/publications/energy-efficient-scotland-route-map/>

- engage strategically with the local authorities to ensure that local authorities are aware of the current condition and plans for the gas network in their local authority area, particularly, for example, the roll out of new connections through the FPNES;
- support local authorities in understanding the options for the gas network in each area of Scotland; and
- as the policy rolls out, take account of each local authority's LHEES when making decisions on network investment.

Fuel Poverty Policy and Fuel Poverty Definition

Scotland has a different Fuel Poverty Policy and Fuel Poverty definition compared with England and Wales. The Scottish definition is expected to be revised this year through the Fuel Poverty (Target, Definition and Strategy) Scotland Bill⁴ which is currently with the Scottish parliament. This will define Fuel Poverty in terms of:

- the ratio of the cost of fuel needed to heat the home to net income, after housing costs;⁵ and
- an income threshold defined for different household types.

Households must fulfil both conditions to be considered in fuel poverty. The Scottish Government will also be setting out the actions it will take to deliver the targets set out in the Bill in a new Fuel Poverty Strategy that is likely to be published in 2020.

It is important that both Ofgem and the network companies understand these substantial differences, and that Ofgem take this in to account when making comparisons across GB to ensure that it's approach is sufficiently flexible to accommodate and work with the different definitions in Scotland.

Scottish Government's targets and priorities

There are several other differences in terms of our ambitions, targets and priorities compared to the UK Government, and which we consider it important for Ofgem to understand and consider when assessing the business plans of network companies operating in Scotland. These include:

- Our ambition to phase out the need for petrol and diesel cars and vans by 2032, as set out in the 2017/18 Programme for Government.
- Through our Energy Efficient Scotland Programme to make our homes and buildings warmer, greener and more efficient by 2040, eliminating poor energy efficiency as a driver of fuel poverty and reducing greenhouse gas.

⁴ <https://www.parliament.scot/parliamentarybusiness/Bills/108916.aspx>

⁵ Housing costs includes rent or mortgage, council tax and charges for water and sewers.

- 100% gross annual electricity consumption in Scotland to come from renewables by 2020.
- 11% of Scotland's non-electrical heat demand to come from renewable sources by 2020.
- The equivalent of 50% of the energy needed for Scotland's heat, transport and electricity consumption to be supplied from renewable sources by 2030
- Smarter local energy – including allowing local priorities and community and regional level to flourish. We want to see 1GW of local and community energy by 2020 and 2GW by 2030.

These ambitions are all part of our Climate Change plan, which sets out how we will meet our statutory target to reduce greenhouse gas emissions by 66% by 2032. The Climate Change Plan will be reviewed following the passage of the Climate Change Bill through Parliament this year. The Bill as introduced increases the ambition of all Scotland's statutory targets, every year until 2050. It proposes the highest targets of any country in the world for 2020, 2030 and 2040, and will mean Scotland is carbon neutral by 2050. Scottish Ministers are committed to achieving net-zero emissions of all greenhouse gases as soon as possible, and will legislate the date for that target as soon as the Committee on Climate Change advice that it is credible and responsible to do so.

National Planning Framework

Our National Planning Framework⁶ sets out our desire to live in sustainable, well-designed places and home, and our vision is for a Scotland with a low carbon economy that achieves growth whilst reducing emissions. Under this framework, all high voltage electricity lines are national developments that are needed to deliver our spatial strategy. Electricity grid enhancements will facilitate increased renewable electricity generation across Scotland – and we therefore expect the network to develop in line with this, which will include mitigating the environmental impacts of new or upgraded high voltage transmission lines.

Control of woodland removal policy

When woodland removal is associated with development, the relevant planning authorities or, in the case of deemed planning permission for applications made under the Electricity Act 1989, Scottish Ministers, are required to determine applications in line with Scottish Government's Policy on Control of Woodland Removal⁷ which can require companies to undertake compensatory planting for the areas of woodland that are felled to construct new networks.

⁶ Available here: <https://www2.gov.scot/Resource/0045/00453683.pdf>.

⁷ Available here: <https://scotland.forestry.gov.uk/images/corporate/pdf/control-of-woodland-removal.pdf>

ANNEX 2 – FEEDBACK ON OFGEM’S CROSS-SECTORAL PROPOSALS FOR RIIO-2

Energy networks are a central part of Scotland’s infrastructure – sustainable development of these networks helps to build our resilience to climate change. Electricity networks play an increasingly important role in facilitating renewable generation across Scotland, while gas networks continue to deliver affordable energy to homes and businesses, and provide flexibility to the wider energy system whilst we look for the best way to decarbonise heat. It is important to recognise the value that these important networks provide – both now and as we progress on the road to decarbonisation.

Delivering network investment while ensuring value for money

We welcome measures in RIIO-2 to save consumers money and deliver better value – provided that networks are still suitably financed and incentivised to invest in and deliver the upgrades required by a decarbonised, decentralised and dynamic system. We support, in principle, the proposed moves towards lower costs of capital, on condition that they accurately and sufficiently reflect the levels of risk and expected returns in the sector, and we welcome the potential that these changes have to save consumers £30/year on their bills.

We also welcome the moves towards fair returns, and the use of return adjustment mechanisms (RAMs) to provide a safeguard to consumers and investors, mitigating the future risk of companies earning materially higher or lower-than-expected returns, and ensuring that companies’ returns better align with the level of risk to which they are exposed. However, we urge Ofgem to work closely with the network companies on the details of RAMs to ensure that the approach used does not undermine incentives on companies to improve service or cut costs for consumers.

Managing uncertainty

We understand the challenge that Ofgem faces when considering the long term level of energy demand, and the extent to which this might be affected by future government decisions – both at UK and Scottish level. Decarbonisation creates the risk that investment decisions made during RIIO-2 will result in assets which are under-utilised in the future. Since these assets are normally depreciated over several decades, this could result in costs in the future being spread over fewer users, and thus future consumers facing higher costs.

Despite this, it is important that where investment is needed during RIIO-2, it can be made. Therefore, to mitigate the risks presented by an uncertain path towards decarbonisation, we would like to see Ofgem use the RIIO-2 process to consider a broad range of approaches when meeting its statutory duty to ensure that network companies can finance their activities. This should include innovative ideas, for example around valuing flexibility and options for the future, new ways of delivering finance, alternative models for the depreciation of assets, or risk sharing.

We agree that, given the levels of uncertainty over how the future of energy will develop, there is a pressing need for uncertainty mechanisms. However, these must

be transparent and agile, with clear processes for implementing and operating these; the network companies will rely upon them to ensure that the investment necessary to support and respond to developments and changing circumstances (eg electric vehicle uptake) are not subject to delay.

Ofgem highlights the potential need for uncertainty mechanisms to accommodate changes to legislation or government policy. For example, the consultation proposes reopeners for Gas Distribution to account for government decision over the decarbonisation of heat. It will be important that Ofgem defines these mechanisms in a way which ensures that devolved responsibilities are accommodated. As we mention in Annex 1, the Scottish Parliament holds devolved responsibility for decisions over decarbonisation of heat and energy efficiency within Scotland, and this competency should be reflected in the wording of the RIIO arrangements for networks within Scotland.

High level priorities for energy networks

The three high-level priorities Ofgem sets out for the gas sector – **customer service**, and in particular the services provided to vulnerable consumers, **sustainable and future proofed networks**, and **safety and resilience** – align at a high-level with the priorities we have identified in our vision for Scotland’s energy networks,⁸ and we believe are applicable across electricity networks too.

Of the three high-level priorities, safety must obviously come first. We would expect to see continuing increases in the safety of the networks. However, it is important that, when replacing any network infrastructure, the option value is also recognised – for example, where relatively low marginal investments can ensure greater flexibility in the future, they should be considered as a viable option.

We agree with the principle that gas networks companies, primarily lead by GDNs, need to continue to play a central role in supporting vulnerable customers. We are aware of concerns among some stakeholders that there isn’t sufficient focus on the role that transmission networks can play in supporting certain vulnerable consumers. While we understand that transmission networks are more removed from end consumers, we urge Ofgem to continue to work with the network companies and to take into account evidence provided on this matter when developing its final decision.

An important aspect of vulnerability is fuel poverty. GDNs are currently incentivised to support this through connecting new households to the gas distribution networks through the Fuel Poor Network Extension Scheme (FPNES). As mentioned earlier, Scotland has a different definition of fuel poverty than England and Wales – we would expect network companies and any support scheme they deliver (including the FPNES) to align with the Scottish definition of fuel poverty when operating in Scotland.

Our fuel poverty team also has substantial experience in understanding the issues around defining Fuel Poverty and would be happy to meet to discuss and share their expertise.

⁸ We set out five priorities: consumer engagement and protection; energy efficiency; system security and flexibility; renewable and low carbon solutions; and oil and gas industry strengths.

Incentives to improve performance and service delivery

Incentives help to focus network companies on priority areas and to find new ways to deliver high quality service than licence conditions alone. We therefore support the use of incentives based on rewards and penalties to encourage certain behaviours and service improvements over and above an already high standard required by licence conditions as an absolute duty. In our view, these incentives should align with short term priorities and long-term energy policy objectives, and should drive year on year improvements over and above the minimum standard.

Secure energy supply is critical to consumers, particularly to vulnerable consumers. Where these supplies fail, network companies should have very strong obligations and incentives both to support those consumers during the loss of supply, and to ensure that they are reconnected quickly.

Some of our stakeholders have raised concerns that Ofgem is prematurely removing incentives, for example around stakeholder engagement and the environment, on the basis that this activity should now be business as usual. We understand the need to 'lock-in' improvements delivered during RIIO-1, and the rationale for embedding behaviours into business as usual activity and baseline costs. However, we urge Ofgem to consider carefully whether now is the right time for these changes, or whether there are other ways to lock in improvements while retaining a focus on delivering even more.

The energy system is changing dramatically; we want to ensure that, while protecting consumers from excessive costs, networks companies are still able to access sufficient funding to deliver safe, reliable and efficient networks for the period of the price control, and also incentivised to continuously improve in priority areas. We think that this is particularly important when thinking about what is best for future consumers. We therefore urge Ofgem to continue to work with the network companies to consider the best way to deliver desired outcomes, and to take into account evidence provided when developing its final decision.

Enhanced stakeholder engagement

An important part of our vision for Scotland's networks is that they develop in a way which considers the impact on all consumers. We therefore welcome the drive in RIIO-2 to build upon and further improve the level of engagement between network companies and their stakeholders. This is important to ensure networks communicate effectively with, and meet the needs of, their users and stakeholders.

We have been engaging closely with the Scottish networks as they develop their business plans, to ensure that they reflect differences between Scottish and UK Government policies and support our ambitions. We expect Ofgem to understand and consider the differences between Scottish and UK Government policies when assessing business plans, and are keen to continue to engage with the network companies and Ofgem as RIIO-2 develops to ensure that our distinct interests, priorities and circumstances are taken in to account.

Innovation

We want to see the culture of innovation fostered in network companies over the last decade to continue to expand, with an increasing focus on incorporating this as business as usual; however, it is important that this happens at the right time, once behaviours are fully embedded as the norm. We welcome measures in RIIO-2 to focus innovation on projects that address the whole energy system and transition, and the desire to see innovation more joined up with government; it is important that this includes the Scottish Government.

We are also keen to see opportunities for innovation and local benefit to emerge across the country. However, the ways in which networks are regulated and funded today means that it is difficult for communities to benefit from the value that they can provide to the wider system. We would like to see Ofgem consider how to enable this as part of its RIIO process.

We welcome proposals to increase third party engagement, and to support new and potentially transformative business models and solutions. Our vision for Scotland's network sets out our desire to see greater opportunities for non-network companies to innovate in support of system and network outcomes, helping networks access flexibility from customers and deliver the service that people and businesses genuinely want.

Support for innovation remains a vital part of accelerating decarbonisation. We announced our intention in 2017 to spend £60 million supporting innovative, low carbon energy infrastructure solutions across Scotland – including battery storage, sustainable heating systems and low emissions transport. Our goal remains to help develop relevant technologies which can support the operation and decarbonisation of Scotland's network infrastructure.

The role of gas networks in decarbonising the energy system during RIIO-2

In 2016, the Climate Change Committee (CCC) highlighted the need to take action now to reduce emissions. This includes the need to decarbonise the gas that flows through our networks, which we believe that gas network companies should increasingly continue to identify and implement opportunities to support this. Therefore, while we understand that it is not the role of the network companies to influence the market or mandate the sources of gas which connect to their network, we are surprised that Ofgem does not propose any outputs related to the role that gas network companies can play in supporting decarbonising the gas that flows through their networks.

In our Network Vision⁹ we highlight the need for the gas industry to work hard on decarbonisation via two parallel approaches – delivering incremental decarbonisation in the short term (including during RIIO-2) through blending of low carbon gases, and delivering the evidence base around the technical feasibility and costs associated with

⁹ A vision for Scotland's electricity and gas network, Scottish Government, March 2019. Available here: <https://www.gov.scot/binaries/content/documents/govscot/publications/publication/2019/03/vision-scotlands-electricity-gas-networks-2030/documents/vision-scotlands-electricity-gas-networks-detail-2019-2030/vision-scotlands-electricity-gas-networks-detail-2019-2030/govscot%3Adocument>

using the gas networks to deliver truly low carbon gas in the future. Developing that evidence base is crucial to enabling bigger, more strategic decisions on decarbonising heat to be taken as soon as is feasible during the next decade.

We believe there is a lot that gas network companies can do to make it easier for low carbon sources of gas to connect to their networks. There is a lot to be learned from the challenges that distributed electricity generation has faced in connecting to the electricity network. Experience in that sector points to a lack of available information for distributed generation developers during the early stages of the boom in distributed renewable generation.

For example, information on network capacities across the distribution network was limited, which led to developers being unable to tailor their projects to locations and capacities suitable to the networks. DNOs now focus more on connections and we have seen a number of improvements, including much clearer connection processes and network capacity heat maps, which help to identify areas where there is capacity for new connections to progress without network reinforcement.

We would like to see outputs put in place which incentivise network companies to (a) ensure that their network is suitable for transporting low carbon gas particularly from distribution connected sites, and (b) that the connections process and the surrounding information is of good quality and enables good connection.

Proposal for the Electricity System Operator

The energy transition makes it more important than ever that the Electricity System Operator (ESO) be empowered to proactively manage the network, and to take whatever steps are necessary to maintain resilient, secure and sustainable systems. We believe that Ofgem is right to recognise the tension between pressure to reduce ESO internal costs while encouraging and enabling proactive investment where this will benefit the system – this tension must be managed carefully throughout the RIIO-2 process.

We also agree with the proposal to maintain the current ESO roles and principles framework for RIIO-2, and with proposals to keep the ESO's code administration, EMR delivery body, data administration, and revenue collection functions in place.

As the body responsible for the day-to-day security of the electricity System across Britain, the ESO will continue to need ancillary services to operate and ensure stability and resilience across the system as well as back up generation – response and reserve services. This will mean continuing the current trend and efforts to open up these markets and to source the relevant services from new and increasingly small-scale parties. These mechanisms need to be designed to take account of the physics, the engineering and the economics of the new providers.

Keeping the system safe will remain the number one priority for network companies and the ESO. However, doing so in a cost-effective way may mean thinking again about the design of some of these systems.