



RIIO-2 Sector Specific Methodology Decision: Summary document



ofgem

Making a positive difference
for energy consumers



This is a summary of our decision on the methodologies which we will use to set price controls for the energy network companies that operate the gas distribution, gas transmission, electricity transmission networks and the electricity system operator.

These are the RIIO-2 price controls.

RIO-2 in context

The GB energy sector is going through a major transformation.



In transport we have started a gradual but probably inexorable shift towards electric vehicles. The way we heat our homes and use energy in our industrial processes is also likely to change as we decarbonise heat to combat climate change. Renewable generation now accounts for about a third of the electricity we generate, compared to **5%** just a decade ago.



How we balance the system is also changing. Demand side measures will help us avoid having to build new generating and network capacity to meet peak demand, as will storage and electric vehicles, which may help to shift demand or release electricity onto the system when it is needed. The way consumers use and buy energy will change too. Smart meters, combined with half hourly settlement and smart technologies, will allow consumers who shift consumption to save money and help balance the system. The realisation and timing of many of these changes is uncertain and this presents challenges and exciting opportunities.



Great Britain's gas and electricity networks sit at the heart of the energy system and will need to be sufficiently flexible and agile to respond to a range of exciting future possibilities. Flexibility will ensure that networks can connect and manage the low carbon technologies required to meet climate change targets, maintain high levels of reliability, at the same time as ensuring that network capacity is not increased unnecessarily or at high cost.



In some situations this approach will require a move away from traditional investment to newer, more flexible solutions, including smart grid technologies and increasing use of flexible contractual arrangements. In the longer term, co-ordinated action between networks could also increasingly deliver much lower whole system costs to consumers. To do this well will involve new thinking, innovation and a transformation in how networks use and share data. If these opportunities are taken, networks will be able to cut costs by reducing the need for expensive new power lines and substations and free up existing grid capacity for new generation and demand.



We are adapting our framework of regulation to enable these changes. In RIO-2 we are placing a renewed focus on the things that really matter to consumers, retaining strong but cost-efficient incentives, encouraging greater efficiency and innovation, while lowering the cost of investing in the networks.

This approach will support the delivery of high quality services but at lower cost, ensuring that the energy networks are fit for a smarter, cleaner energy future that is fair to all consumers.

Background

The gas and electricity networks in Great Britain are run by private companies who have a monopoly on the operation of these networks.

These networks have a critical role to play in ensuring a safe, reliable and affordable supply of energy is provided wherever and whenever it is needed. Our principal objective is to protect the interests of existing and future consumers, including those in vulnerable situations or that are poorly served. We achieve this by ensuring they get value through the efficient and sustainable operation of the networks and delivery of associated services.

We set price controls that determine the revenues networks can recover so that consumer interests are protected. The cost of operating, maintaining and strengthening these networks is significant, currently averaging around **£12.5 billion** each year. This represents around **25%** of the energy bill.

Since 2013, we have used the RIIO framework to set price controls. The next RIIO price controls (RIIO-2) will begin in 2021 for the gas distribution and gas and electricity transmission networks, and the electricity system operator¹.



The first set of RIIO price controls have high-powered incentives over a long 8-year control period. They also provide a strong innovation stimulus through additional funding. However, the overall costs to consumers have still turned out to be higher than they needed to be.



Reliability has improved and customer satisfaction is high. Costs have come down relative to the budgets set at the start and innovation has improved efficiency and learning among networks.



In certain cases, the returns that companies have earned is due to some budgets being set too high, and some performance targets set too low. The allowed return was also based on assumptions that turned out, in hindsight, to be wrong.

A long price control period means we have to wait longer to make the adjustments we deem necessary to correct these problems.

¹While a number of the overarching principles of RIIO will apply to the ESO, the practical application of these principles may be different.

For today's consumers:

RIIO-2 will reflect consumer preferences, and deliver high quality services at low cost

Our methodologies **will keep quality of service high for existing consumers, with costs being much lower than they would otherwise be**. We are doing this by setting revenues to reflect a lower cost of financing these businesses. We will tighten expenditure allowances and service quality targets and introduce new mechanisms to reduce the risk of forecasting error. We will also extend the use of competition where market pressures could drive better value solutions.



We want companies to strive for efficiency but we are increasing the share of any cost savings that consumers receive, compared to current levels. We are putting more protections in place against unforeseen events driving high costs and profits.

- A shorter price control of 5 years.
- Targeting outputs and incentives on the things that really matter to consumers.
- Tough scrutiny of company spending plans including through the RIIO-2 Challenge Group and the company-level stakeholder groups.
- Using competition to drive efficiency.
- Setting budgets so that a sector on average is expected to receive sufficient funding. Retaining strong incentives for good business plans and efficient delivery.
- Reducing the harm to consumers from forecasting errors by indexing rather than using forecasts where we choose to reflect price effects in key variables such as interest rates, construction and labour prices.
- Reducing the returns that can be paid to equity investors².
- Return adjustment mechanisms to give consumers a greater share of high returns.



With local preferences accounted for through the engagement process.



Competition for both solutions to network problems and delivery of projects.



Our working assumption is that this will move from **7-8%** in RIIO-1 to **4.8%** (CPIH-real) to align better with current market conditions and the risk environment.

²Our working assumption for the expected return for RIIO-2 is 4.8% (CPIH-real) at this stage. For the allowed return, the working assumption is 4.3% (CPIH-real). The difference between the two is a working assumption for an ex-ante expectation of outperformance against incentives. Firm numbers will only be consulted on in summer 2020, and confirmed at the final determinations stage at end-2020.

For the consumers of tomorrow

RIO-2 will support the energy system transition and decarbonisation

Lower costs in the short-term will not be at the expense of investing for the future. We are taking special care to ensure that moving to a shorter price control period and setting tighter cost allowances will not come at the expense of long-term network health or properly preparing the networks for the energy system of the future.



The energy system is changing and this will require changes in how networks operate. **We are strengthening existing mechanisms and introducing new arrangements so that networks can facilitate the decarbonisation of power, heat and transport, the decentralization of the energy system and the development of smarter homes and grids.**

We are retaining a strong innovation funding programme.

Outputs and incentives will support speedy connections for new demands and sources of generation and storage. Strong incentives on expenditure will encourage networks to use flexibility providers and markets to avoid expensive reinforcement.

We are introducing new mechanisms that will support the delivery of solutions to benefit the 'whole system'.

We are introducing measures that will encourage companies to maintain long-term asset health and to improve their resilience against cyber-attacks.

Network companies must act responsibly towards the environment and consider how they can play an effective role in the wider drive for decarbonisation.



Our innovation support will provide a strategic fund for large transformational investments. This will help to solve the major R&D problems that networks face, such as how to adapt to future requirements for low carbon heat and electric vehicles. We are also retaining but reforming the Network Innovation Allowance to enable smaller scale "sparks" to fly. It will be primarily aimed at supporting the energy system transition, while ensuring that vulnerable consumers do not get left behind.



We will set outputs and funding across all sectors to reduce each network's direct carbon footprint and funding for transmission operators to reduce the visual impact of their network.

We will monitor and incentivise the contribution each network makes in the wider decarbonisation of the power, transport and heat sectors.

For vulnerable consumers:

RIO-2 will provide additional support for those consumers in vulnerable situations

We recognise that consumers in vulnerable situations need additional support as they may be more dependent on a reliable supply of energy than most and/or the services that network companies provide could make a significant difference to their quality of life.



Our measures to reduce the cost of networks while improving services will benefit these consumers, but in addition we are increasing the support that network companies provide to consumers in vulnerable situations.

- **Introducing new requirements on companies to take into account consumer vulnerability in all services they provide**
- **Networks should join up with local providers and charities to offer integrated energy solutions to vulnerable consumers.**
- **Better targeted funding to connect fuel poor households to the gas grid, where appropriate.**
- **Innovation support to ensure consumers in vulnerable situations do not get left behind as the energy system changes.**



We are carving out a dedicated allowance specifically to fund initiatives that offer additional benefit to vulnerable consumers.



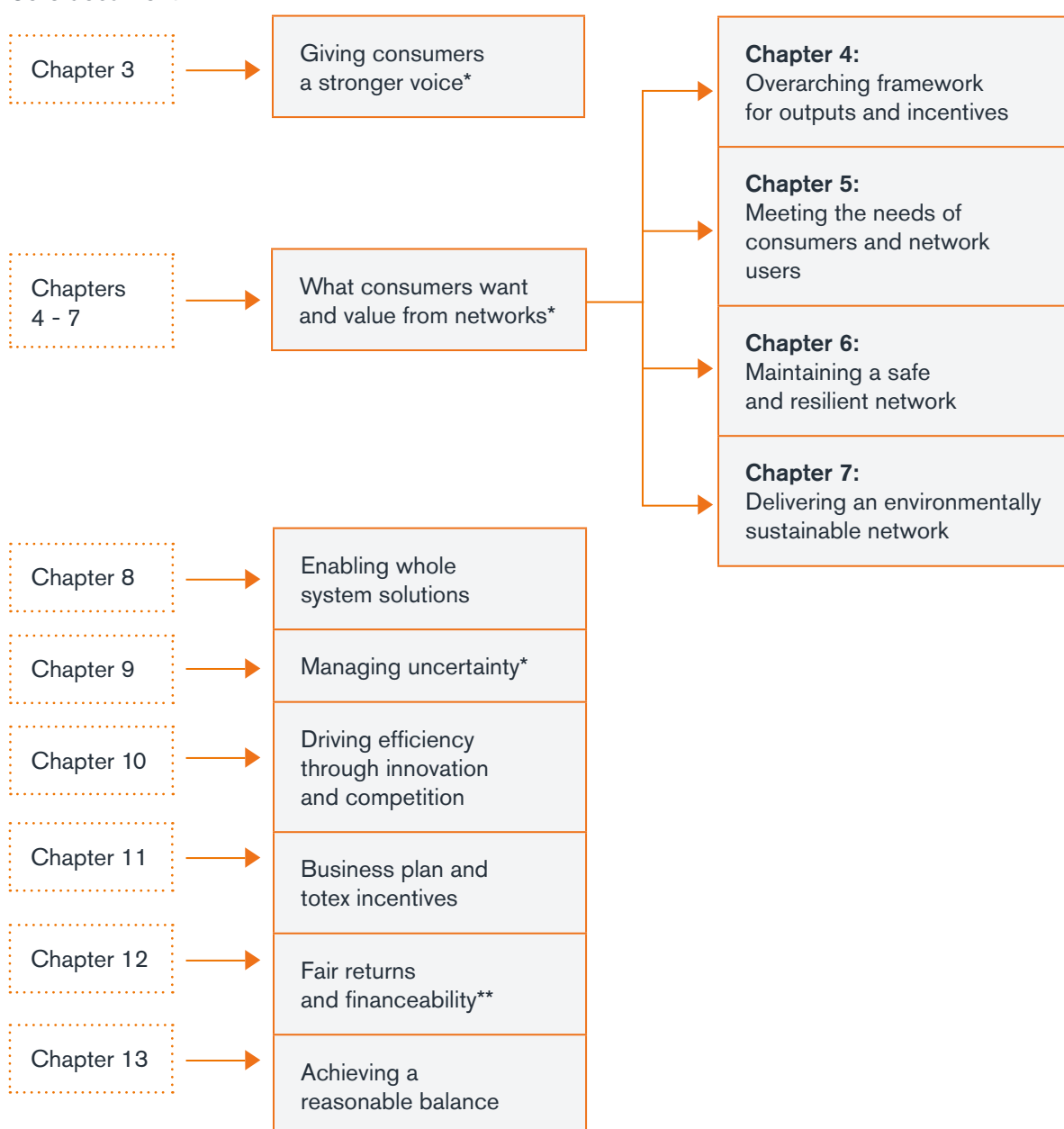
Reforming innovation funding to support projects that have the potential to benefit vulnerable or poorly served consumers.

Want to know more about RIIO-2?

We have summarised above the main changes we are making to the RIIO-2 methodology. This is provided alongside our core decision document and sector specific methodology decision documents for the gas distribution, gas transmission, electricity transmission network companies and the electricity system operator. Use the map below to see where you can find out more.

In the event of any apparent conflict between this summary and the methodology decision documents, the methodology decision documents take precedence.

Core document



*More detail is provided in the sector specific methodologies

**More detail is provided in the Financial Annex