



Making a positive difference
for energy consumers

To Network Companies and
System Operators

Email: RIIO2@ofgem.gov.uk

Date: 08 August 2019

Dear network and system operators,

RIIO-2 response to Committee on Climate Change's Net Zero Report

This letter is to provide further clarity on the approach we expect you to adopt towards scenarios and forecasting for the purposes of your investment planning and Business Plans.

In May 2019, the Committee on Climate Change (CCC) released their publication *Net Zero – The UK's contribution to stopping global warming*.¹ In this report, the CCC responded to a request from the Governments of the UK, Wales and Scotland and recommended a new emissions target for the UK of net zero greenhouse gases by 2050 (the Net Zero target). In June 2019, the UK and Scottish Governments then introduced legislation to implement this target.² This has implications for the role of networks, their investment planning, and their valuation of a carbon price, in supporting such a target.

Investment planning

Previous to this, Ofgem had requested networks to work collaboratively to develop a 'common view of the future' to inform the planning of baseline revenues. The networks outlined the results of their work in the ENA's March 2019 *Common RIIO-2 Scenario* report. Given some concerns around the ENA report, including a lack of sufficient detail for Ofgem to appropriately scrutinise many elements, Ofgem sought to protect consumers' interests by requesting that for planning baseline revenue requirements networks should use the minimum values specified in the ENA report. Ofgem also stated that it expects the networks to demonstrate that their Business Plans were sufficiently flexible to meet a range of different outcomes, including existing environmental targets and commitments of Governments of the UK, Wales and Scotland where relevant.

Achieving the legislated target of net zero by 2050 requires a consideration of the plausible range of pathways through which this target could be achieved. One pathway, for example, could be a world of complete electrification and fully decarbonised generation. In another, the energy sector may see a significant role for hydrogen networks and carbon capture and storage. Therefore, in response to the CCC recommendation, networks should still plan their baseline revenues on the ENA report minimum values, but we now expect networks to **clearly propose and evidence how their Business Plans are able to flex to support**

¹ Available at: <https://www.theccc.org.uk/publication/net-zero-the-uks-contribution-to-stopping-global-warming/>

² UK Government press statement available at: <https://www.gov.uk/government/news/pm-theresa-may-we-will-end-uk-contribution-to-climate-change-by-2050>. Scottish Government press statement available at: <https://www.gov.scot/news/climate-change-action-1/>

achieving the Net Zero target in line with a range of such pathways. The 'flex' in this regard will be facilitated, in general, by uncertainty mechanisms which enable Ofgem to award additional revenue in a timely fashion to meet new investments as their value to existing and future consumers becomes apparent. We note that these mechanisms should be symmetrical in nature, and we expect their design to also facilitate reductions in revenue requirements if any of the earmarked investments are deemed unnecessary in the future.

Ofgem will work together with the networks, the energy system operators, the CCC, the Department for Business, Energy and Industrial Strategy (BEIS), and other parties where relevant to identify potential network investment associated with pathways to support the Net Zero target.

In their Business Plans, networks will need to:³

- **identify where their baseline investment plan may impede the efficient achievement of any of these pathways, and**
- **propose how their Business Plans can flex to address these impediments and facilitate timely investments which support potential pathways.**

We have previously provided guidance on highly anticipatory investment.⁴ Some investments of this nature may provide additional optionality or cost-efficiencies for achieving pathways to the Net Zero target. Networks should carefully reconsider the opportunity for undertaking such investments, and should explicitly identify subsequent proposals in their Business Plan which support Net Zero pathways. For example, the CCC notes that the approach to grid capacity augmentation should be somewhat 'future proof', meaning that where upgrades occur, they should be to a size sufficient to ensure no future augmentation at the relevant site would be required prior to 2050. Ofgem will thoroughly consider proposals which are clearly evidenced, and demonstrate a sufficient likelihood the investment will be needed to support pathways to achieving the Net Zero target.

In our Business Plan Guidance,⁵ we note that for Business Plans to be of satisfactory quality they must be **well justified**. Determining this includes consideration of whether proposals are supported by robust and substantiated evidence. For projects raised by networks explicitly in order to support the Net Zero target, we acknowledge that there will be significant levels of uncertainty associated with long term planning. As such, our expectations of 'well justified' for projects specifically intended to support achieving the Net Zero target will be tailored appropriately.

With regard to the gas sectors, we will also undertake work to consider the implication of different pathways on the requisite 'payback periods' for investment, and will require that proposed investment planning for 2050 pathways is consistent with assumptions underpinning the pathway in question.

Carbon pricing

One fundamental element of the option-selection process for potential network projects is the cost benefit analyses that network companies will submit to us with their Business Plans. Our current methodology requires network companies to calculate environmental impacts, including the reduction in carbon emissions and other greenhouse gases such as methane. These are converted into monetary values according to official guidance from the Government.

³ For the avoidance of doubt, this will constitute one of the minimum requirements of a Business Plan under Stage 1 of the Business Plan Incentive.

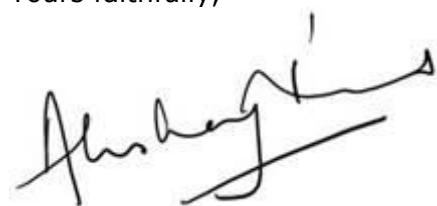
⁴ See especially Chapter 9 of the RIIO-2 Sector Specific Methodology Decision, available at: <https://www.ofgem.gov.uk/publications-and-updates/riio-2-sector-specific-methodology-decision>

⁵ Available at: <https://www.ofgem.gov.uk/publications-and-updates/riio-2-business-plans-draft-guidance-document>

Partly in response to the Net Zero target, **we are currently in the process of updating our guidance concerning the valuation of carbon emissions in a network context.** We aim to work with network companies to produce a more sophisticated analysis which is more in line with the new carbon targets. In practical terms, **this may involve companies identifying the subset of projects where the investment decisions are sensitive to a higher carbon value** (ie, a higher carbon value would change the eventual investment decision). The use of higher carbon values must be consistent with the pathway analysis in question. For example, in a world of fully decarbonised power generation, the carbon value of electricity losses would be zero (ie, the forecast carbon intensity of the network must be consistent with the forecast in question).

We look forward to working with the networks on ensuring they are well positioned and resourced to support the Net Zero target.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Akshay Kaul', with a long horizontal stroke extending to the right.

Akshay Kaul
Director – Network Price Controls, Systems & Networks