Grid Edge Policy
Regulation · Energy · Consumers

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To: RIIO2@ofgem.gov.uk

Ofgem's RIIO ED2 open letter

Dear RIIO team,

Until 2016 I was Senior Partner Networks at Ofgem where I led on the RIIO ED1 price control. I am now an independent consultant and thought leader on energy regulation with a particular focus on the consumer interest. I also chair SGN's Consumer Engagement Group, am a member of SSEN's Consumer Engagement Group and an Associate with Sustainability First. This response is submitted in a personal capacity and is focused on the more technical regulatory issues in the open letter, drawing on my 20+ years of regulatory experience across the public and private sectors.

In terms of context, the requirement to achieve net zero carbon emissions by 2050 (or 2045 in Scotland) should be a central consideration for ED2. This increased focus on de-carbonisation is a critical shift since the RIIO2 Framework was published and all aspects of the Framework should be reviewed through that lens.

Comments on some of the specific questions raised in the open letter are given in the attached annex.

Yours sincerely

Maxine Frerk

Director Grid Edge Policy

Annex: Answers to questions in the open letter

Q1: Objectives

No comment

Q2-5: How to drive for outcomes dependent on the actions of others

Ofgem is right to expect DNOs to contribute to delivery of de-carbonisation of heat and transport (and to consider how to incentivise that) but correctly identifies the problem that meeting targets in these areas will be dependent on wider policy developments and the actions of others.

Sustainability First explored these challenges in its discussion paper on a Low Carbon Incentive and proposed an approach that was based on a combination of qualitative and quantitative approaches to incentives, building on the current ESO incentive arrangements.

Q6-8 Strategic investment

The National Infrastructure Commission and the Committee on Climate Change have both highlighted the need for strategic investment if climate change targets are to be met.

Where cities and local authorities (as elected bodies) have ambitions to move faster on de-carbonisation and have clear plans for doing so then it is important that network investment is not a barrier to them doing so, if the regulatory process is to have democratic legitimacy.

While Ofgem has legitimate concerns about highly anticipatory investment, new ways of thinking about the handling of uncertainty – and potentially new governance arrangements – are needed to ensure that this does not hold back these ambitions.

My Grid Edge Policy paper on Real Options Assessment explores some of the issues around investment under uncertainty including, for example, the use of probabilistic CBAs or "trigger points" which ENW have used.

The report also stresses that what "real options" theory drives is a new way of thinking about what the options are (invest to learn, keeping options open, etc) and the value in breaking decisions down into phases with regular re-appraisal. This is also reflected in academic work on decision making under uncertainty, for example a recent presentation at UCL by Dr Katy Roelich[1] which points to techniques such as "adaptive decision making". This required "mindset shift" does not come through in Ofgem's consultation.

In considering strategic investment there are also important links with Ofgem's work on charging methodologies and in particular on Access arrangements which govern who should pay for necessary reinforcement.

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1 https://www.ucl.ac.uk/bartlett/energy/sites/bartlett/files/decision_making_under_uncertainty_katy_roelich.pdf

Q9-11 DSO Separation

Ofgem is right that it would be disproportionate at this stage to require separation of the DSO roles (which would likely entail duplication of resources and additional costs). However it is important that the DSO is seen as a neutral market facilitator and companies should not put barriers in the way to unbundling should that prove to be justified in future.

Q12 Innovation

Ofgem has put a strong emphasis on third party led innovation projects. While there is benefit in trying to bring in ideas from as wide a pool as possible, there are questions about the appropriateness of significant consumer funding going to third parties without the rigour of a proper competitive process and where the benefits that accrue to them in the competitive market place cannot be recouped for consumers in the way that they are with the regulated network companies. A clearer sense of where government funding is appropriate (as distinct from funding through the price control) would be helpful.

Q13-14 Totex and flexibility

Ofgem has raised the question of how best to deal with flexibility services which offer an alternative to traditional reinforcement.

In debating this it should be remembered that the use of totex (together with the Totex Incentive Mechanism) was a regulatory innovation aimed explicitly at encouraging the companies to consider opex solutions on an equal footing with capex. In my view it has worked in terms of driving some of the initial use of ANM and flexibility in ED1.

However as the potential use of flexibility services is expected to expand significantly in ED2 Ofgem is right to test whether this existing mechanism works effectively. In particular Ofgem raise a concern that flexibility will be cheaper and that companies will gain unduly if baseline revenues are set based on traditional reinforcement. However to my mind this is not the issue.

Clearly there will be challenges in setting baseline revenues where flexibility costs would potentially be incurred on an ongoing basis (as distinct from the one-off costs of capex investment) so while they may be cheaper in the short term they may not be over the longer term. Moreover, as noted in my paper on Real Options Assessment there may actually be value in flexibility solutions even if they were more costly (when properly assessed) because of the option value they create. The problem is not so much that flexibility is cheaper but that what you get is actually a different outcome and the incentive design and benchmarking need to take account of this.

However Ofgem's suggestion that flexibility services should simply be reimbursed at the cost that comes from the tender seems to remove any incentive on the DNO to design tenders in a way that is most likely to deliver cost effective solutions and to look properly at the trade-offs between flexibility and reinforcement.

This is a complex area and Ofgem should look at examples of how DNOs are currently making these trade-offs in order to inform its thinking on the best regulatory approach.

Q15-17 Data

No comments

Q18-19

The use of a 5 year control would seem appropriate for ED2 given the rapid pace of change in the sector.

Q20 Enhanced engagement

In my experience the enhanced engagement arrangements have added real value in GD2 with SGN's CEG having significantly shaped and improved their plan. However there would clearly be value in a more formal lessons learned exercise which could help inform the ED2 process. In particular I believe there is a need for greater clarity around the distinct roles of the CEGs and the CCG and also for a clear timetable to be set out in advance as to what the CCG will want when.

Q21-23 Outputs and incentives

The output categories are sufficiently broad that they should be able to cover all relevant areas.

I have raised concerns previously about Ofgem's proposal to set incentives on a relative basis. From a regulatory design point of view this is misguided because:

- to be most effective companies need to be clear what they need to do to earn rewards (or avoid penalties). It will be much harder for them to make the business case for investment to support improved service if they cannot be confident of the financial impacts of so doing;

- companies will be discouraged from sharing best practice which is important in raising standards across the industry;

- it is hard to talk to customers about willingness to pay for improvements in service when what they will have to pay will depend on the performance of other companies. Where performance can be objectively measured what matters to customers is how their local network performs;

- Ofgem have previously suggested that this will drive competition between the companies. In practice there is already a level of rivalry (as each wants to be top of the performance tables) but not such as to hamper co-operation where needed.

- Moreover – applying game theory concepts - it will not be hard for companies to reach a common understanding that they will all take a cautious approach to maximise industry returns.

I have argued previously that there should be no rewards for "winning the fat boys race" – it is absolute not relative performance that matters. Clearly there can be some areas where absolute performance is hard to measure – for example on stakeholder engagement – and in such cases a relative incentive would be reasonable (and probably happens de facto anyway). That said in most such cases where performance is harder to quantify Ofgem seems to be planning to drop financial incentives so the point is moot.

On the issue of dynamic incentives, it makes sense in most areas that targets should get tougher over time. However there is still a difference between setting targets that tighten in a pre-defined way and targets that change depending on industry performance. These issues were explored during the CMA appeal on ED1 and at that time Ofgem argued that it was important that DNOs understood what was expected of them in terms of performance in setting their business plans. It remains unclear how the costs of delivering improved performance are meant to be recovered – whether from the incentive rewards or as part of base business case costs. If the latter then Ofgem needs to be clear how that is taken into account in benchmarking (to avoid costs being determined on the basis of an unambitious plan from a customer service perspective). Ofgem also needs to think through how changing the targets based on performance during the price control would impact on incentives to improve (if the reward will be a tougher target). Again this was explored in the CMA appeal. While dynamic targets may sound intuitively appealing from a consumer perspective Ofgem needs to ensure that it has worked through all the potential unintended consequences before experimenting with a new model.

Q23 Vulnerable customers

It is hard to be prescriptive about the protections needed and DNOs should be incentivised to look for opportunities, not just to protect vulnerable customers but to ensure that they are able to participate in and benefit from the transition. For example, electric storage heating is widely used by lower income households and offers a potentially valuable source of flexibility that DNOs should be being proactive in working out how best to harness.

Q24-27 Resilience

No comment

Q28-30 Environmentally Sustainable network

See comments above on incentivising outcomes affected by others' actions (Q2-5) and on strategic investment (Q6-8).

Losses remains an important environmental issue (at least until generation is fully de-carbonised) and needs specific attention.

For wider aspects of the companies' business carbon footprint there is real value in a consistent approach being taken to Environmental Action Plans and annual reporting as applies for GD2 and T2. This will make it easier for stakeholders and reinforce the reputational incentives that are being relied on in this area.

Q31-32 Whole systems

No comment

Q33-37 Managing Uncertainty

See response to Q6-8 on strategic investment.

Q38-41 Innovation and Competition

No comment

Q42: Forecasting and scenarios

There are challenges with the requirement for a consistent view of the future. The view developed for GD2 was overtaken by updated FES scenarios and the new net zero requirement. Conceptually the emphasis should be on understanding the range of uncertainties and what factors are most critical in terms of different elements of costs. The “consistent view of the future” process was probably helpful in starting to tease some of this out but it is important that the emphasis is on managing the uncertainty rather than on trying to reach consensus on a single forecast.

Q43-44 BPI and TIM

I agree with the removal of fast track (based on the experience of ED1).

It is still very unclear how the BPI and TIM will work in GD2 (including what Ofgem are looking for from the Customer Value Proposition). Given this is a completely new set of arrangements there would seem to be real value in seeing how this process looks to be working out in practice in the other sectors and then hopefully being able to refine the thinking and provide clearer guidance in advance for ED2.

Q45-47 Fair returns and Q48 RAMs

It is clearly important that companies cannot earn excessive returns but equally an undue focus on constraining returns risks not providing adequate incentives for companies to deliver the outcomes that are being sought. Given the climate challenge in particular this would be a real concern.

The idea of a sculpted sharing factor is one that I have advocated from the start. It is always hard for a regulator to distinguish outperformance that is genuinely the result of strong efficiency from outperformance that is achieved by padding the original business plan forecasts. It does seem that the greater the outperformance the greater the chance that this reflects over-bidding in the plan process and hence a reduced sharing factor would seem appropriate.

The other mechanisms that have been explored such as anchoring would seem to remove the incentive from companies to outperform and leave the rewards that they get dependent on the performance of other companies (which would not provide them with the confidence to invest).