

Open Letter Consultation on the RIIO-ED2 Price Control

RenewableUK response

October 2019

RenewableUK's members are building our future energy system, powered by clean electricity. We bring them together to deliver that future faster; a future which is better for industry, billpayers, and the environment. We support over 400 member companies to ensure increasing amounts of renewable electricity are deployed across the UK and to access export markets all over the world. Our members are business leaders, technology innovators, and expert thinkers from right across industry.

Thank you for the opportunity to respond to the open letter consultation on the approach to setting the next electricity distribution price control (RIIO-ED2).

We support Ofgem's approach to the RIIO-2 programme – collaborating with industry at the early stages of the development of the next price control for electricity distribution. We encourage Ofgem to continue to engage with the wider industry as RIIO-ED2 work goes forward into subsequent stages. Our response has been compiled by RenewableUK with input from our membership.

Proposed objectives for RIIO-ED2

1. Do you have any views on the proposed objective for RIIO-ED2?

We believe the objective should more explicitly address efforts to achieve net zero. This could be linked to capabilities needed to be developed to support the delivery of a decarbonised, decentralised and digitalised network at distribution level.

Strategic approach to RIIO-ED2

- 2. To what extent should we take into account outcomes linked to decarbonisation targets, and what outcomes might this involve?**
- 3. Are there activities that DNOs are best placed to carry out in order to achieve these outcomes? What are the alternatives? Why would it be appropriate for energy consumers to fund these activities?**
- 4. How should we assess DNO funding requirements and measure DNO performance in these areas?**
- 5. How should we incentivise DNO performance when the achievement of outcomes could be dependent on the actions of others?**

With increasing amount of coordination across the whole electricity system, outcomes related to decarbonisation and ability to operate local distribution networks carbon-free will become more prevalent during RIIO-ED2. This will be a major stepping stone for full decarbonisation of the electricity system.

The Climate Change Act underpins the move to a low-carbon, flexible system. Barriers to achieving this include:

- Speed at which renewable generation can deploy and connect to the distribution networks
- Constraints on the system restricting the System Operators ability to draw on all low carbon resources (e.g. distribution connected parties participating in national markets such as the Balancing Mechanism)
- Lack of opportunity for renewable technologies to compete in technology neutral capacity and ancillary markets.

While some of these issues are being addressed, for example, through National Grid programme on future of balancing services and trialling local distributed markets for flexibility, the commitments to achieve net-zero by 2050 place an urgency for decarbonisation of the electricity system to happen more swiftly.

The price control framework needs to be more agile and encourage network companies to continue to remove barriers to ever increasing amounts of renewables and innovative flexible technologies. Whole system approaches and network incentives should explicitly support a grid carbon intensity that is aligned with the fifth carbon budget. It is worth noting that the beginning of the fifth carbon budget coincides with the end of the proposed 5-year ED-2 price control and therefore a huge amount of change will have to be delivered within the RIIO-2 control period.

There is benefit in incentivising a more efficient outage planning process as distribution network operators (DNOs) transition to distribution system operators (DSOs) against a defined counterfactual. This could be in the form of measuring the 'kWhr lost' from renewable generation as a result of planned network outage – such record could be used as a KPI to incentivise efficient network monitoring and system operation. It would incentivise DNOs to provide alternative solutions to enable generators to continue to export. There is currently no visibility or recording of whether certain regions experience high volumes of non-BM compensated output and such a view would be useful to support the development of distribution level Network Options Assessment (NOA) process and conclusions. It ultimately highlights to consumers how effectively renewable energy technologies, such as wind, are being integrated into the wider system. At transmission level, payments for wider constraints are recorded via the BM but non-compensated volumes are ignored so the true picture of total green energy 'lost' is not visible to anyone.

Furthermore, there is greater need to monitor asset utilisation while ensuring network assets are sized appropriately. Currently the totex incentive rewards companies for effectively managing system requirements; however, the mechanism does not track the success of utilising existing assets. This could be achieved either via the introduction of a capital efficiency target or by making the ratio between maximum capacity and the average load on a network a primary metric for adjusting network company revenues. The assessment should be applicable to generation and demand led constraints.

How to set price controls that support strategic investment

- 6. How do we ensure that network companies are best placed to undertake strategic investment and manage the associated risk? How should the risks of these investments be managed?**
- 7. What, if any, changes to the framework are required to support strategic investment?**

8. How should we hold the companies to account for the delivery of strategic investment, and the outcomes that they are expected to deliver?

Only recently the government launched a consultation proposing changes to the building regulations to introduce a Future Homes Standard for all UK homes, which would ban fossil fuel heating systems by 2025¹. This will have very significant implications for heat decarbonisation as well as the future of the electricity networks during RII0-ED2 price control.

The price control framework should ensure network preparedness to accommodate systemic change, such as rapid electrification of road transport and roll out of EV charge points. Recent figures from the Society of Motor Manufacturers & Traders (SMMT) have revealed a five-fold rise in zero emission vehicle purchases to the year to date²; at this rate battery electric vehicles are set to surpass current National Grid FES19 Consumer Evolution projections.

To support a smooth transition and deliver environmental gains now, we need long-term commitment to measures that give consumers confidence to invest in the latest technologies that best suit their needs. Both current and future consumers benefit from investments made today. The price control framework should ensure the cost of large capital investments is spread overtime, with the benefits likely to be borne by future network users over the lifetime of the asset.

We support the view that nearly all network investment should be considered anticipatory as it is taken ahead of a need. Should DNOs be funded for carrying out strategic investment activities appropriate criteria, triggers for such investment and rate of return should be developed. Uncertainty mechanisms should be built to manage risk and release funding once the need is confirmed.

The Flexibility Commitment³ which will see distribution network operators open up requirements for new network infrastructure to include flexibility service providers, will have significant implications for electricity distribution. This could be an essential component that allows a systems wide perspective to be taken and will need to be factored into any future options assessment and consumer benefit from network investment.

We support the Committee on Climate Change's recommendation that at the point network infrastructure is upgraded, capacity is augmented sufficiently to avoid the need for any further upgrades to 2050 in order to achieve legally binding net-zero targets. However, we recognise that it will be essentially a network operator decision to opt for reinforcing the distribution network. A mechanism should be developed to allow for a transparent options assessment between network built and non-network-built solutions (e.g. use of tenders for provision of services). At present this is somewhat of a grey area and it is the responsibility

¹ Ministry of Housing, Communities & Local Government, 'The Future Homes Standard: changes to Part L and Part F of the Building Regulations for new dwellings', October 2019 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/835536/Future_Homes_Standard_Consultation_Oct_2019.pdf

² Society of Motor Manufacturers & Traders, 'UK electric car registrations surge in August but it's a long road to zero and barriers must be addressed', September 2019 <https://www.smmt.co.uk/2019/09/uk-electric-car-registrations-surge-in-august-but-its-a-long-road-to-zero-and-barriers-must-be-addressed/>

³ Energy Networks Association, 'Flexibility Commitment', December 2018 <http://www.energynetworks.org/assets/files/ENA%20Flex%20Commitment.pdf>

of Ofgem to define a transparent regulatory framework so that there is increased investor/market confidence.

There is a need to set out mechanism for Distribution Network Options Assessment as part of RIIO-ED2. Currently there is no incentive or output which recognises the fundamental role of NOA process at distribution. Changes to the framework need to ensure DNOs could take the necessary steps and improve planning process.

How to set price controls for DSO functions

- 9. Is there a need to separate out the revenues and outputs for ‘traditional’ DNO functions from DSO functions? How could this be achieved?**
- 10. In the event of the DSO function being delivered by a separate party, how might we determine the revenues for DSO activities? What type of funding model would be appropriate to set DSO revenues? In this event, would changes also be required to DNO revenues and outputs?**
- 11. Where a DNO is undertaking a DSO function, what type of outputs or outcomes are necessary to measure how efficiently they are performing this function? Over what time period could these be measured?**

The funding framework by which the DNOs recover opex spend related to DSO functions should be reviewed. Currently DSO expenditure is recovered from the overall totex allowance, while a separate recovery of spend would make the process more transparent.

We support the Energy Network Association’s work which is focused on consistent approach to neutral market facilitation from legally joined up DNO and DSO. The neutral market facilitation role can only be achieved through appropriate identification and separation of the DSO and DNO roles – and how they are distinctive from each other. When making a decision on the future DSO design, Ofgem would need to consider whether there would be any consumer benefit of splitting the DNO and DSO to mitigate the conflict of interest. This is a scenario not currently within the scope of the ENA’s Future Worlds modelling. We have set out our thinking on this as part of our response to the Future Worlds consultation.

We are concerned that the DNO will not have aligned drivers with the DSO in the long run. The ESO, in its enhanced role and legally separated from the other National Grid companies, has clearer drivers to be able to plan an optimal system. However, the DNOs, as businesses with different funding and incentive arrangements from the ESO, have a financial incentive to increase the overall volume of distribution assets and will not have the same incentive to adopt non-build network options.

How to set price controls that drive innovation and competition

- 12. In what ways could the existing arrangements drive more innovation and competition?**

AND

How to set price controls for a smart, flexible energy system

- 13. To what extent should we set (and incentivise performance against) baseline totex allowances for activities where flexible solutions could be provided?**
- 14. Should we instead set allowances based on the costs revealed through the flexibility tendering process? How might this work?**

DSO revenues should not be linked to the total costs of the services procured through the local tenders to flexibility and other system services, but the development and operation of efficient markets. The approach should draw on the benefits of the ESO price control framework and focus on delivering good outcomes for consumers and energy system as a whole.

With monopolistic power, we believe, that DNO/DSOs should procure flexibility services for all aspects of managing their networks and keep tools such as Active Network Management (ANM) in reserve, only to be used to protect the network in extreme cases where flexibility is insufficient. This will help create more liquid local flexibility markets and help reduce costs for consumers. While ANM arrangements are entered into voluntarily, it is more often the case that developer must either accept ANM or abandon the project.

How to set price controls in a big data environment

- 15. To what degree should DNOs modernise their handling practices to adhere to data best practice, and therefore (among other things) provide available, transparent, and interoperable data about their networks? What measures will be needed to ensure data remains secure?**
- 16. How should we structure RIIO-ED2 to encourage metadata to be made available, and for data to be presumed open? How should we measure DNO performance in this area, and on what basis should funding be set to deliver relevant outcomes?**
- 17. Do you agree with the themes we plan to include in our guidance on data best practice?**

Under current practices DNOs already capture information about each of their assets. We understand that the level of detail varies by asset, with issues such as data scarcity, patchy data or data not even digitalised most prevalent. In any case, network operators will need to examine additional data such as historical load, asset age and data not readily available in-house, such as meteorological information.

Advanced analytics techniques should be adopted across network operators as part of data best practice.

We note there is a difference between big data and high-quality data and this should be reflected by the DNOs. While we agree network operators should aim to realise the full potential of data in RIIO-ED2, we do not think there is a need for specific data incentive to be put in place which rewards the DNO for good data management performance. Efficient operation of networks and local system management goes hand in hand with improved data management performance and thus expectation should be appropriately linked to the delivery of efficient whole energy system.

We support the Energy Data Task Force recommendation that a common metadata standard should apply. We note that at transmission level, operators have information stored in supervisory control and data acquisition (SCADA) systems.

RIIO-ED2 Framework Consultation

Length of price control

- 18. We welcome views on our proposed position of a five-year price control for RIIO-ED2.**

19. Are there any elements of RIIO-ED2 price control that we should consider setting over a longer or shorter period? Please give reasons.

We support the proposals for a five-year price control. Between 2021 and 2028 we can expect to see huge change on the system, and this will need to be reflected in the way the system is regulated. We cannot envisage specific circumstances where longer price controls may be necessary, but would be open to this if a good case is made. However, when this does occur, it is important that these are reviewed regularly, and targets rebased against the wider framework, keeping the long-term and whole system needs in mind.

Giving consumer a stronger voice

20. We welcome views on whether these enhanced engagement arrangements are appropriate for RIIO-ED2.

Network management is complex, and scrutiny of business plans takes time and expertise. In the creation of consumer and user groups, Ofgem must ensure that Network Operators put in the time and resource to both recruit the right members with the relevant knowledge and expertise and provide the necessary support to them. Network operations will need to publish business plans which are clear enough for these groups to assess, as well as other network users to properly scrutinise and provide feedback on.

Meeting the needs of consumers and network users

21. We welcome views on whether the proposed output categories and incentive arrangements are appropriate for RIIO-ED2.

22. We are interested to hear if there are new elements of the services DNOs will need to deliver that should be included in the current output categories.

Alternatively, we welcome views on whether these should be captured by a new output category. For these new elements, we are interested to hear how delivery of these services should be valued and measured.

23. We welcome thoughts on how to ensure that we continue to protect the interests of vulnerable consumers, particularly in light of the energy system transition.

We agree with the views set out in the consultation regarding the delivery of core network services and the incentives and output categories associated with this.

As the DSO transition accelerates the value of flexibility and system operation needs to be reflected in the framework. The current output categories and incentive arrangements do not clearly present this change. New categories should require DSOs to demonstrate approaches to long-term commitments which could deliver greater consumer benefits and provide the necessary certainty to connected projects when making investment decisions. We expect that over the course of RIIO-ED2 there is standardisation of DNO medium-term flexibility signals through tenders or even markets.

Maintaining a safe and resilient network

24. We welcome views on how DNOs should continue to ensure their networks are resilient, particularly in the context of the new or changing way assets are used.

- 25. We are interested to hear stakeholder views on how DNOs should ensure their networks are resilient to physical and/or virtual threats, as well as being able to withstand the effects of adverse weather and the impacts of climate change.**
- 26. We would also like to hear how stakeholders believe climate change mitigation and adaptation may affect network maintenance and development in the short, medium, and long term.**
- 27. We would like to hear views on how we ensure DNOs remain resilient to the challenges presented by an ageing and changing workforce.**

We agree with the view that delivery of safe and resilient network should be at the heart of what DNOs doing. A revenue support model for the DNOs/DSOs should incentivise the delivery of the lowest cost provision of services. We support the view that asset performance should be measured taking into account the long-term effects that the companies are funded to do during RIIO-2, reflecting the value of benefits to future and existing consumers.

We oppose the proposal to regulate the approaches to workforce management and resilience. The benefit of a modern, well-trained and high-quality workforce could be better captured by the efficient delivery of service, appropriately managing the risk of overcompensation.

Delivering an environmentally sustainable network

- 28. We welcome views on how DNOs should work to minimise the impact of what they do on the environment and facilitate the transition to a low carbon energy system. We are particularly interested in the implications of the government's updated target of netzero emissions by 2050.**
- 29. We also welcome views on what this may mean for the type of activities networks undertake, how these may be funded, as well as the outputs and/or incentives they should be exposed to.**
- 30. Finally, we are keen to understand how DNOs' performance should be measured, and how we should assess the value that consumers place on the provision of these services and activities.**

We do not think the outlined proposals present an ambitious framework for distribution networks on a path to deliver net-zero by 2050.

We have set out our thinking on how DNOs/DSOs could play a much more strategic role in delivery of UK's decarbonisation agenda as part of our response to Q1-Q5.

Enabling whole system solutions

- 31. We welcome views on how RIIO-ED2 can best capture the benefit of whole systems solutions. We are also interested in views on how these benefits should be measured.**
- 32. We further welcome stakeholders' opinions on whether the electricity distribution sector's approach to whole systems should be different from the other sectors and, if so, why.**

The main benefit from adopting whole system practices to decision making will be increasingly lower whole system costs to consumers. Distribution-connected renewable energy resources will have more choice when it comes to supporting system actions, leading to increased competition for certain types of networks assets to the benefit of consumers.

We are broadly supportive of the outlined approach to enabling whole system solutions. However, we see there is merit to explore a whole system incentive mechanism focused on innovation in combination with the coordination and information sharing incentive.

A specific coordination and information sharing incentive will also improve visibility between traditional system boundaries and the current process of options assessment between TOs and DNOs in particular. The Network Access Policy (NAP) already covers effective exchange of information on planning and outages within the transmission network but there is no similar mechanism for cross boundary cooperation.

Ofgem needs to assure that the Interest of Consumer test is robust. A relatively narrow focus for whole system should take into account the long-term interests of current and future generations as underlined by decarbonisation targets and in line with Ofgem's statutory duties.

Managing uncertainty

- 33. We welcome views on how we should manage the uncertainty associated with forecasting allowances, and whether there are any mechanisms we could or should consider in helping to manage this uncertainty.**
- 34. We seek views on the use of indexation, particularly on any adjustments for labour and construction cost inflation.**
- 35. We welcome views on our approach to highly anticipatory investment projects. We are interested to hear whether stakeholders would suggest additional processes or regimes for facilitating such investments that support the energy system transition whilst protecting consumers from potentially inefficient investments.**
- 36. We welcome views on the type of issues that should be considered through an interinstitutional group.**
- 37. We invite stakeholders to advise what type of expenditure they believe should be subject to alternative arrangements for sharing risk, and what these arrangements may look like.**

We support the view that the next price control framework should reflect the need for greater decarbonisation and, in doing so, should enable anticipatory investment in grid infrastructure which would facilitate the integration of planned and prospective renewable energy and flexible technologies. While we understand the drive to use indexation to minimise uncertainty behind investment, we do not think the costs related to flexibility procurement should be within the scope.

Driving efficiency through innovation and competition

- 38. We welcome views on the proposed innovation stimulus. We are interested to hear views on the types of projects that should be funded through either the NIA funding or a new funding pot.**
- 39. How can the benefits of the innovation stimulus be maximised by supporting schemes proposed by non-network parties?**
- 40. We also welcome views on our proposals for the different competition models in RIIO-ED2, and what, if any, criteria should be set out for the use of early or late stage competition models.**
- 41. We also seek input from stakeholders on how native competition obligations and best practices can be used to ensure the best outcomes for consumers**

and to drive changes in the role of the networks in a transforming energy system.

We are broadly supportive of the proposals regarding the innovation stimulus. We suggest Ofgem considers an additional option where a tailored innovation funding for distribution system operation is set, aimed at addressing the energy transition challenge and recognising the unique role of the DSO.

The models identified for late and early competition are appropriate. We agree with Ofgem's assertion that early competitions, particularly in electricity distribution, could produce benefits for consumers by revealing new or innovative ways of solving network problems (such as grid constraints) and avoiding expensive reinforcement costs by opening up network requirements to flexibility providers.

Forecasting and scenarios

- 42. We welcome views on our approach to planning, forecasting and scenarios for RIIOD2. In particular, do stakeholders have other suggestions as to how we can best manage forecasting risk for consumers?**

The outlined approach seems sensible.

Business plan and totex incentives

- 43. We welcome views on our proposal to remove the early settlement process for RIIOD2, instead focusing on alternative mechanisms to receive high-quality and ambitious business plans.**
- 44. We also welcome views on our proposals to use the Business Plan Incentive and the confidence-dependent incentive rate arrangements for RIIOD2. In line with this, we are interested to hear stakeholder views on the range that should be used for both of these.**

We broadly agree with the proposals to replace the early settlement process with the Business Plan Incentive.

We note that the use of confidence-dependent incentive rates, where greater rates are rewarded to high-confidence areas, might not align with the outlined objectives for RIIOD2. We are concerned that this approach might introduce a perverse incentive for network companies to de-prioritise ambition in areas which they are less confident in, such as procurement of services as alternative to network-built option.

Fair returns and financeability

- 45. We welcome stakeholder views on our proposals to introduce measures to enable network companies to finance their activities whilst ensuring they receive a fair return.**
- 46. We are interested to hear from stakeholders on how they believe we should set allowances for the cost of debt, particularly around the method of recalibrating the index.**
- 47. We also welcome views on our proposed approach to setting allowances for the cost of equity, as well as our proposal to move away from RPI.**
- 48. Finally, we would like to hear stakeholders' views on our proposed introduction of a 'sculpted sharing factor' in instances of high out- or under-performance, or whether an alternative mechanism could be more effective.**



Targeting the cost of debt for a comparable infrastructure company is a reasonable approach.

While delivering energy networks is complex, and subject to a great amount of change over the coming decade, it is also regulated monopoly industry, with regulated returns, and therefore relatively secure investment. With this in mind, it is reasonable that there is a return on equity in line with similar industries, but reflects the lowered risk/return profile.