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Essen, 15 October 2019

**Consultation on the RIIO-ED2 Price Control – RWE Response**

Dear James,

RWE welcomes the opportunity to respond to the BEIS and Ofgem “Open Letter Consultation on approach to setting the next electricity distribution price control (RIIO-ED2)” published on 6th August 2019 (the Consultation Document). We are responding on behalf of RWE Renewables International GmbH, RWE Supply & Trading GmbH and RWE Generation plc (RWE). This is a non-confidential response.

Growing renewable energy is the clear focus of the new RWE. The renewable energy portfolios of E.ON and innogy, combined to form RWE Renewables International GmbH, will turn the company into a global player with an installed capacity of more than 9 gigawatts. Added to this are further assets with a combined capacity of 2.6 gigawatts under construction that will be completed in the near future. The world’s No. 2 in offshore wind and Europe’s No. 3 in renewable energy – these are the starting positions that the company intends to consolidate and strengthen. RWE will provide an annual 1.5 billion euros in net capital expenditure for both offshore and onshore wind turbines as well as photovoltaics and storage.

Almost 25% of our renewables generation capacities are located in the UK, making it one of our most important markets and focus for future investment.

Therefore we would like to state suggestions on how the RIIO framework might be amended to make it fit for further renewables growth.

If you have questions on the positions stated further below, please do not hesitate to come back to me.

Kind regards,

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## Executive Summary

DNOs need to be encouraged / incentivised to connect renewable generation. Ofgem should create a framework for strategic investment (rather than opposing it), recognising that competition in generation pushing down power prices can outweigh the cost of “strategic” investment. Ofgem must ensure appropriate separation between DNOs and DSOs. It is not too early. There are real concerns that the DSO role is being devised behind closed door in the Open Networks Project. Ofgem must ensure the DNOs support competition – Ofgem’s drive to facilitate DNO competition and innovation is only the second best option – it should rather be the market that should deliver competition and innovation. As well as separating DNOs and DSOs, Ofgem should regulate them separately. Data is of high value and key to energy revolution: ensure it is collected, robust and shared.

## Strategic approach to RII02-ED2

### How to set price controls that support decarbonization

*DNOs need to be encouraged / incentivized to connect renewable generation.*

The Government has adopted a net zero carbon target to be delivered by 2050. This will require a significant increase in the amount of renewable generation connected to the system. The intermittent nature of most renewable generation will also have implications for the mix on the system, particularly if baseload nuclear closes and is not replaced. Thus, particular attention should be paid to ensuring that the DNOs connect renewable generation, efficiently and in a timely manner, given these Government targets. Local generation for local use.

In our experience, the DNOs are too often a barrier to connecting renewable generation, whether this is an unduly high connection charge, an infeasible connection date, or interaction with the transmission system. The connection process should be significantly simplified. It will also help if the review of the connection boundary moves from shallow-ish to shallow, more in line with the TO model.

It would be possible to put specific incentives on the DNOs to introduce a connect and manage regime. This would clearly need some careful analysis as the intermittent nature of renewable generation is likely to see a role for conventional generation (possibly carbon based) for some time yet. We appreciate capacity sharing is being considered as part of the Ofgem access and forward looking charges Significant Code Review, but it will be important that renewables get access to the network where sharing does occur, unless there is a technical reason that cannot happen.

Ofgem has a key role to play here.

At the very least, Ofgem must offer a joined up policy framework. We note that in this document, Ofgem is consulting on ways to get the price controls to support the decarbonization agenda. Ofgem must work toward policy targets, taking advantage of the fall in the costs of renewables to deliver lower cost carbon reductions, rather than creating new barriers to their deployment.

## **How to set price controls that support strategic investment**

*Ofgem should create a framework for strategic investment (rather than opposing it), recognising that competition in generation pushing down power prices can outweigh the cost of “strategic” investment.*

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We support the idea that the DNOs should be allowed to make strategic investments. In our view, this means that more capacity will be provided than is actually justified by current demand. “Over-capacity” will enable more renewables to be connected, as well as enhancing competition between generators.

We believe that Ofgem has for too long focused on delivering the minimum level of investment necessary in order to achieve “the lowest prices possible”. This focus on the minimum level of DNO investment we think means that overall costs to customers are in fact higher than they need to be. That is, minimizing DNO investment limits competition between generators. We believe that enhancing competition between generators is more likely to lead to lower prices.

While Ofgem has done considerable work in managing connection queues, we feel the queues are responsible for a significant share of the costs of development. We know we may have to pursue 4-6 sites in looking for a new development, with each costing £m and most deemed not economic due to the costs or timelines imposed by the DNOs. The costs of these abandoned projects must then be spread over the next developments we do, so pushing up the costs of delivering GB generation.

There are many industries where there is some inbuilt redundancy, as it is recognised that this ultimately provides for flexibility and greater resilience. With the growth in embedded generation, the move to new renewables without support granted, changes in environmental targets, etc., now is the time for Ofgem to consider where their policy to allow for the lowest possible capacity should be reviewed as it is creating a barrier to delivering government policy goals.

Another trade-off that should be considered is the quantum of DNO investment versus the cost of capital. We believe that Ofgem has applied a very generous cost of capital against a lower than necessary capital investment program. We believe that a lower cost of capital on a higher investment program would be better for customers.

We note that in the BEIS document on the use of a RAB model in nuclear power that they suggest that there is a lot of capital looking to invest businesses operating under a RAB price control. If this is true, then the cost of capital should be lower than under recent price controls, both in energy and other regulated companies.

Later in the document, Ofgem asks for views on the length of the price control. We recommend a price control of 5 years. The RIIO-1 price control has allowed the DNOs to earn excess returns. Reversion to 5 years should help to address the over recovery of the DNOs and allow for changes in response to wider market changes.

## **How to set price controls for DSO functions**

*Ofgem must ensure appropriate separation between DNOs and DSOs. It is not too early. The market has real concerns that the DSO role is being devised behind closed doors in the Open Networks Project.*

It is clear that the role of DNOs is evolving and that there is an emerging new DSO function.

Much thought was put into whether the ESO and TO should be split. Ofgem should insist on legal separation between the DSO function and the DNO, as we can see no reason why the same policy approach would not be taken at the distribution level. In fact, it is more important to pursue this separation as soon as possible due to the way that the DNO's operations are more opaque than the ESO's actions.

There will be significant growth in intermittent generation and storage at the distribution level. This growth will be hindered if the DNOs are allowed to act in the DSO flexibility markets that will have to be developed. Until the DNO / DSO split is mandated, DNOs will always favor system investment over market solutions. We do not consider it to be acceptable or conducive to innovation to allow monopolies to operate in competitive markets. Those DNOs who have developed services in the ancillary services markets, be that investment avoidance or service provisions, they should be separated from ALL of their monopoly activities.

If Ofgem is reluctant to pursue the DNO / DSO split at this time, then it might be possible to change the way in which system investment is justified. DNOs could be required to justify that a market solution has been considered before system investment is allowed. What we think will not work in the face of the ever changing market is complicated incentive mechanisms to deliver innovation. Market will deliver innovative solutions.

As a first step Ofgem should accounting separation between the DSO and the DNO. Evidence from all other sectors where separation has been mandated shows that this results in appropriate cost allocation between the businesses. Ofgem will need to set accounting guidelines to ensure that such cost allocation reveals sensible cost transparency. We find that once cost transparency has been established, the push for separation will be accelerated.

On a procedural point, we do not believe that the DNOs, as part of the "Open Networks" project should be developing the policy towards DSOs. There is a clear conflict of interest. They have not consulted on some of the decisions they have made, such as the publication of data, nor are they listening when parties are telling them to stop work on unacceptable models like the single buyer options.

We welcome Ofgem and BEIS' recent letter to the DNOs about the way the Open Networks project is being run and we fully support the attempts to get the process to move faster. However, it is also important that the process is far more open and inclusive. It is not acceptable that the DNOs are creating new business models behind closed doors and must therefore be guessing at what the parties in the competitive part of the market and their customers require.

## **How to set price controls that drive innovation and competition**

*Ensure the DNOs support competition – Ofgem's drive to facilitate DNO competition and innovation is only the second best option – it should rather be the market that should deliver competition and innovation.*

We start from the assumption that competition and competitive markets are the best way to deliver innovation, as economically and efficiently as possible. Structures should be put in place to ensure that companies can compete. Where there are natural monopolies, we consider that it can be artificial to put innovation incentives on the DNOs, with the success of such innovation being judged, not by the market, but by Ofgem. Where they need an innovative solution to a problem they should go to the market and ask for their help, not just get given customers money to test out their own ideas.

Two structural issues have already been raised in this response already that are relevant for this question.

First, Ofgem should pursue the concept of strategic investment, which would increase the amount of generation (including renewable) generation that could be connected, allowing different solutions to issues to be trialled. As an example the DNOs may want to use EVs to help manage the networks. Maybe more flexible and accessible storage facilities would be a better option.

Second, Ofgem should ensure the separation of DNO and DSO as soon as possible. We are disappointed that Ofgem's DSO Position Paper is not more aggressive in the timetable for separation. A separate DSO company each region can engage with the ESO about how they buy local vs national services. They should also be working a contractual framework that allows parties to sign one framework agreement that can cover deals with the ESO and all of the DNOs on the same basis. As well as competitive markets, we need the DSOs to act transparently so that the market can see which services are being used when and by whom. This will help inform the market about where to invest and what to invest in; information is the key to effective competition.

We see that Ofgem seeks to stimulate innovation in the DNOs. We are not convinced that this is good use of the DNOs' or Ofgem's time. More and more ever complicated incentive mechanisms distracts the DNOs from what is their prime responsibility which should be to provide capacity to connect generation and demand. It is also not clear that either Ofgem nor the DNOs are parties best place to promote innovative ideas compared to many other parties in the market.

Our view on this issue is that despite years of innovation incentives, most of the DNOs are not becoming more innovative, but instead spend their customers' money on schemes that the competitive markets are likely to deliver more efficiently. Competition amongst competitive companies is the best way to stimu-

late innovation to the benefit of customers. DNOs should be a platform for competition, providing all of the relevant data, but not competitive in their own right. Where monopolies are allowed in competitive markets they put off other innovators who do not believe they will get fair access, or equitable treatment of their asset over the host DNOs. The DNOs also have far lower costs of capital, so can undercut those in the competitive market who may have developed an innovative idea, but they DNO then comes along and takes the basic idea but can give themselves cheaper market access.

As an international company, we have experience of regulators seeking to promote competition with established monopolies. We find that the effort required to introduce this type of competition rarely seems to be successful. Based on this experience, we recommend that Ofgem concentrates on the regulation of the networks, using a much lower cost of capital than currently.

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

*Separate DNO and DSO and regulate separately.*

The fundamental issue here is to separate the DNO from the DSO element of network companies. The DNO should provide capacity (including strategic capacity) and the DSO can procure flexibility from the market. An asset based price control, with a low cost of capital, would be set for the network business. Some form of incentive based price control would be set for the DSOs for operating their networks efficiently. Ofgem has already outlined this approach for the National Grid, and we see no reason not to pursue the same agenda at the distribution level.

In the smart, flexible world, data will be key. We believe that there is insufficient attention being put into obtaining data on the distribution systems (illustrated by DCUSA mod DCP350). Issues such as the volume of EVs connecting, the level of embedded generation, the interaction between distribution and transmission systems remain issues that seem to cause problems for all market participants. Thus, a major push to collect – and publish – data on the operation of the systems would be a way to set price controls.

It seems likely that the growth in demand side response will be an important way for DSOs to manage the system. To the extent that markets are developed to deliver flexibility, it will be important to ensure that intermittent generation competes on a level playing field with DSR. This will be achieved by sensible product design, which is more likely if the functional split is pursued.

Again we would like to stress the need to make sure that the rules for access to the market are as aligned as they can be between the ESO and all of the DSOs. We understand that the ESO is meant to be working towards a framework covering more than one ancillary service. We very much hope that the DSOs will be part of this work and make sure that they align their services descriptions, the contracting requirements, data flows, use of IT etc. If all the DSOs do their own thing the market will become increasingly fragmented, impacting levels of competition and the efficiency of the market.



## **How to set price controls in a big data environment**

*Data is key to energy revolution, so Ofgem must ensure it is collected, robust and shared in an easily accessible format.*

It is difficult to answer this question until it can be established what data exists and where there are holes in datasets. We are surprised that we still have such a lack of data (on e.g. EVs, embedded generation, etc.) being given as a reason why policy initiatives are not pursued. The DNOs must be tasked with improving the knowledge of the level and type of generation and demand connected to their systems. It will be important that any enhanced data set is available to market participants. In this way, market solutions will be more likely to evolve. The level of information available to those connected to the transmission network should be replicated at the distribution level.

Clearly, once sufficient data integrity can be achieved, it would be possible to begin to consider about some of the more innovative solutions to system issues. Thus, more data on consumer usage, would allow products aimed at securing consumer flexibility could be developed. However, the collection and presentation of this data may require some upfront investment, but it is the data the DNOs should also need to most efficiently manage their own businesses. Ofgem should ensure that the DNOs to get their data into far better order in a timely manner. Again they need to take the market with them, it is not just data they need, it is data the ESO needs, Ofgem needs and the competitive parties need.

## **Selected responses to the RIIO-ED2 Framework Consultation**

We have not responded to every question in the framework consultation, as we some of the issues are not well enough defined to give helpful answers. However, to summarise our key issues for the price control setting process:

- Length of price control – we consider, as set out above, that a 5 year price control would be appropriate;
- Giving consumers a stronger voice – in principle this is a good idea, but we note that it can be quite difficult to obtain the view of end consumers;
- Delivering an environmentally sustainable network – emphasis should be put on facilitating the efficient and timely delivery of renewables in order to deliver a zero carbon world;
- Managing uncertainty – to prevent the DNOs over-recovering again, there should be greater emphasis on indexation and pass-through of costs (including financing costs);
- Fair returns and finance ability – we urge Ofgem to set a return that would challenge the network companies to make their returns as we believe the network companies have been over-recovering for too long;
- Debt indexation – we agree with the concept of debt indexation as it should limit the returns of the network companies; and
- Return adjustment mechanisms – we agree with introducing such “claw-back” tools.