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Energy UK Response – Ofgem open letter consultation on the RIIO-ED2 Price Control

Submitted via email only

Energy UK is the trade association for the energy industry with over 100 members spanning every aspect of the energy sector – from established FTSE 100 companies right through to new, growing suppliers and generators, which now make up over half of our membership.

We represent the diverse nature of the UK's energy industry with our members delivering almost all (90%) of both the UK's power generation and energy supply for over 27 million UK homes as well as businesses.

The energy industry invests over £13.1bn annually, delivers around £85.6bn in economic activity through its supply chain and interaction with other sectors, and supports over 764,000 jobs in every corner of the country.

Energy UK welcomes the opportunity to respond to this consultation as well as the continuing work of the Open Networks project. The work of the project continues to be an important part of forming the groundwork, in terms of continued information gathering, ahead of Ofgem decisions on future roles, responsibilities and processes across a smart flexible energy system.

Energy UK believes that, in order to create a level playing field for all actors that wish to perform DSO functions, activity in this area should be separated from the DNO licence. This is not to say that DNOs cannot perform those functions where appropriate mitigation of conflicts of interest is in place, but will prevent the need to separate these regulatory functions at a later date as was the case with the ESO and TO functions.

This response should be examined alongside Energy UK's response to Ofgem's Position Paper on Distribution System Operation, as the two responses are heavily related.

Energy UK will continue full engagement with this policy area and welcomes any questions from Ofgem or wider stakeholders regarding this response.

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Strategic Approach to RIIO-ED2

How to set price controls that support decarbonisation goals

2. To what extent should we take into account outcomes linked to decarbonisation targets, and what outcomes might this involve?

As the UK adopts a net zero target, it is vital that all energy system actors contribute to reaching that target. Ensuring that energy networks are enabling further decarbonisation will be a challenging but important element of price controls in the coming years. Much of the complexity in this area lies in the definition of tangible outputs against which to measure progress.

In its July 2018 framework decision, Ofgem indicated its intention “to ensure that company business planning processes subject new investment to higher hurdles (particularly testing network reinforcement options against alternative options such as demand-side measures and storage)”. Ofgem may, therefore, wish to take into account the societal benefits of carbon emissions savings as part of DNOs’ proposed investments. This would be consistent with the current Strategic Wider Works (SWW) evaluation process, as well as business plan proposals under the Network Innovation Competition (NIC), in which the monetised value of carbon emissions is already considered.

The core activity for network operators across both gas and electricity will be in enabling investment in low carbon at lowest cost to consumers. Coordinating with local planning for the decarbonisation of heat, power, transport and industry could deliver significant benefits in terms of effective and efficient decarbonisation. Energy UK’s Future of Energy series discussed the benefits of local planning of low carbon heat, but we do not have specific views on how to integrate this into network outcomes.

Energy UK is progressing work with the Energy Systems Catapult and others to explore options for local decarbonisation plans and will keep Ofgem informed as that develops.

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?

There is an emerging role for DNOs in collaborating with local authorities to enable lowest cost decarbonisation in line with regional and national ambitions. As long as this activity delivers decarbonisation at lower cost to consumers, it seems sensible to fund this as part of BAU. For example, coordinating major renovations or town planning with the installation of EV chargepoints would require input and guidance from the relevant DNO.

This is a theme that has emerged across a range of policy areas in recent years, from London’s attempts to integrate the increasing range of distributed energy assets to the anticipated recommendations of the EV Energy Taskforce. While the surrounding requirements, including measurements of success, will be difficult to define, it is clear that greater efforts would be welcome from all networks in enabling faster decarbonisation through coordination with a range of bodies.

It would, however, have to be demonstrated that any carbon benefits would not be realisable without participation of the relevant DNO, or at least that participation by the DNO would lead to substantially higher carbon savings, to legitimise energy consumers funding this activity.

It would be beneficial for a standard process of interaction and information sharing to be established across all DNOs to simplify the process for local authorities and industry actors. Energy UK is participating in the steering group for Workstream 4 of the Open Network project, which is beginning to explore this, and that group would welcome additional input and thoughts from Ofgem.

4. How should we assess DNO funding requirements and measure DNO performance in these areas?

Energy UK is unable to define an appropriate funding requirement for this activity, but would note that measurement of performance in these areas could be delivered using a wide range of metrics. Metrics of most relevance could include: surveys of local authorities and industry actors to explore the ease with which they felt able to coordinate with the DNO; assessments of the number of connected low carbon assets; and assessments market growth of low carbon technologies year on year within that DNO's region.

5. *How should we incentivise DNO performance when the achievement of outcomes could be dependent on the actions of others?*

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How to set price controls for DSO functions

6. *Is there a need to separate out the revenues and outputs for 'traditional' DNO functions from DSO functions? How could this be achieved?*

Yes.

Energy UK supports separation of the revenues and outputs of DSO functions given the importance of removing any potential conflicts and reflective of Ofgem's current position of enabling a range of actors to provide these functions¹. Given the broad range of functions that fit under the definition of distribution system operation, it seems sensible to approach this as a new activity and to establish a principle based governance framework for these activities until such a time as Ofgem decides upon the appropriate form and function of a DSO.

To fold DSO functions into the DNO licence at this time would curtail innovation and create an uneven playing field for those wishing to develop capabilities in these areas. Beyond this it would also act as a clear statement from Ofgem that DNOs are expected to take on the role of DSO within their existing licence and without significant separation of these functions. This would undermine investor confidence as developing conflicts of interest have yet to be addressed.

Alongside maintaining a level playing field for those delivering DSO functions, Ofgem should progress work set out in the Smart Systems and Flexibility Plan as a matter of urgency, particularly in the development of market mechanisms for flexibility and the implementation of the recommendations of the Energy Data Taskforce. Where DNOs do take on DSO functions, Ofgem should ensure that these are appropriately separated from existing activities to prevent conflicts of interests.

It is the understanding of Energy UK that Ofgem wishes to delay any decision on defining a DSO body or in codifying functions in order to allow for innovation and a range of options to continue to emerge. This position restricts the available actions for Ofgem, particularly in terms of creating a separate licence to deliver separation of functions reflective of the separation of ESO and TO.

Energy UK would note that a gradual and incremental separation of DNO and DSO functions is expected to result in sunk costs and an administrative burden in relation to mitigation of conflicts of interest. Setting out these functions as separate from the activities of a DNO may simplify any future separation of these activities and reduce overall costs to consumers.

In order to achieve separation of revenues and outputs it may, therefore, be appropriate for Ofgem to request notification from any actor participating in or interested in developing DSO functions. Once a holistic list of those organisations is developed, Ofgem can establish ways to ensure coordination and collaboration by creating a principles based regulatory approach with certain incentives and checks on acceptable revenues.

¹ <https://www.ofgem.gov.uk/publications-and-updates/ofgem-position-paper-distribution-system-operation-our-approach-and-regulatory-priorities>

Alternatively, BEIS and Ofgem could collaborate in the development of an innovation competition, with an open tender for organisations to deliver these functions and test the potential for conflicts of interest and the capabilities of each business model. This would build upon the work already progressed by a number of actors across the UK while also opening up the ability to innovate beyond the current reliance on innovation funding awarded to DNOs.

7. 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?

Again, Energy UK would note that an approach which separates DSO functions from the DNO licence, if not from the DNOs allowable activities, would enable a range of different bodies to take on these functions and be fairly and transparently remunerated for any contributions to the safe and efficient operation of the system. Creating a separate licence may be appropriate in this instance.

Regardless of the approach taken, there is a need to define and clarify the allowable revenues for DNOs in active network management and other activities which encroach upon DSO functions. Where these functions interact with or interfere with DSO functions, Ofgem will need to clarify how conflicts can be addressed. This will be the case regardless of which organisations take on DSO functions.

8. 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?

There are potential benefits in aligning DSO revenues to the successful growth of markets for flexibility in their region. This will ensure a focus on developing effective market mechanisms and engaging with potential providers, and, in the case of DNOs taking on DSO functions, will mitigate the potential for an apparent market failure to be used to justify traditional investment or investment in network assets capable of delivering flexibility.

There may also be benefits in measuring the amount of low carbon generation that has been utilised in any given period. For example, if the DNO is performing DSO functions but has consistently curtailed low carbon generators at times of low demand instead of tendering for demand turn-up services, they may not be effectively optimising the use of existing assets.

If a DNO is awarding a high number of 'flexible' connections and curtailing users instead of utilising a market mechanism to realise flexibility, the revenues available to that DNO should be lower than those awarded to a DNO with few flexible connections and a high number of market participants.

Energy UK would expect that, at least until DSO functions are further defined and established, the performance of all actors taking on DSO functions would be assessed on a yearly basis to enable changes to regulation reflective of emerging conflicts of interest and unintended consequences. It would be appropriate to ensure that all actors performing DSO functions are being assessed fairly and transparently, whether they are a DNO or other actor.