

**Submission from Catherine Mitchell, Professor of Energy Policy, University of Exeter
Energy Policy Group (EPG) to the Ofgem Consultation on the RIIO2 Draft Determination
Core Document¹**

Introduction

It is with great pleasure that I submit this short note to the RIIO2 Draft Determination consultation on Transmission and Gas Distribution networks and the ESO. I was leading a project called Innovation and Governance for a Future Energy System (IGov, 2012-2019). The IGov team, part of the University of Exeter Energy Policy Group (EPG) have inputted to various RIIO consultations in the past, mainly to do with electricity distribution networks. Our previous arguments can be found in a RIIO 'primer'².

My colleague Richard Lowes of the EPG has already sent in a note on the innovation aspects of this consultation. I would like it noted that I agree with the points he raises and I will not spend time in this note on innovation.

In general, there is much of value within this consultation document. I am pleased that there is a greater focus on net zero and on the centrality of consumers and the means to genuinely involve them more in decisions. I liked the setting out of the building blocks of the price control (page 14, figure 1); the new approach of uncertainty mechanisms, especially the reopeners (eg page 56); and the discussion on improving innovation.

When reading Ofgem documents, I usually feel that Ofgem says the 'right' things with respect to the environment, incentives and outputs but that they rarely go further and put incentive in place which will deliver those 'right' stated points (such as the required outputs or an improved environmental outcome). I do feel with this document that, as usual, Ofgem does say the 'right' things and there has been a more successful attempt to granularize details necessary to deliver desired outputs (for

¹ https://www.ofgem.gov.uk/system/files/docs/2020/07/draft_determinations_-_core_document_redacted.pdf

² <http://projects.exeter.ac.uk/igov/primer-riio/>

example, the building blocks of incentives which should lead to the general stated outcomes; the differences in uncertainty mechanisms).

However, unfortunately, in order to deliver outcomes more needs to be said about what outcomes are wanted by when, and how they are to be assessed; what institutions and roles will be required to deliver those outcomes; and what incentives are needed to deliver those outcomes, given those institutions and roles. From my perspective, there are two key points about this:

- first, that it is mainly not Ofgem's fault that the institutional energy governance framework necessary to deliver net zero (and other desired outcomes like an efficient energy system) in Britain is not in place and has not so far been deeply and widely addressed. This is the Government's, and currently BEIS's in particular, responsibility. Without the appropriate institutions in place and new roles established, where necessary through changed Duties etc, Ofgem can only provide a very disjointed determination document. The documents incentives, by their nature, are not going to be helpful for anything other than fundamentally continuing the not fit for purpose governance framework and the more or less BAU activities. It certainly cannot hit net zero or encourage innovation;
- second, whilst Ofgem has, as said above, said the 'right' things in terms of desired outputs, it has not alluded at all to the extent that it has been constrained by the point above. As a result, the determination appears to do three things: it sets up RII02 incentives to be (1) strangely siloed from each other within the whole energy system or (2) to have determinations which ignore major policy decisions which have to be taken by Government (such as what to do with fossil gas networks; in what sectors do we think hydrogen will be used (or not); how do networks link with Government energy efficiency policy) but which have not been taken yet; or (3) to not be incentivising a progressive net zero energy system – the very thing it sets out to do (for example, not providing sufficient incentives to turn the ESO into an active system operator which multiplies the value of services).

This note slightly amplifies what is good about this draft determination in section 3 and it amplifies some of the 2 bullet points above in Section 4. In Section 2, it provides a short introduction to a fit for purpose energy governance framework.

Section 2

Basic Requirements of a Fit for Purpose Energy Governance Framework

The Ofgem consultation is setting out draft determinations on a framework which is not fit for purpose for delivering a net zero energy system. In a sense, it is set up to fail.

IGov³ has set out a 'straw' framework⁴ and central to that are: a coordinating body⁵ (a energy transformation commission, set up by similar statutes to the CCC); an integrated and independent system operator (joint heat and electricity which is state owned and which oversees system transformation)⁶; altering the Duties of Ofgem⁷; enlarged market arrangements (additional balancing and coordinating markets at the local level)⁸; DNOs transferring to distribution service providers

³ <http://projects.exeter.ac.uk/igov/>

⁴ <http://projects.exeter.ac.uk/igov/shortcut-to-key-igov-findings/>

⁵ <http://projects.exeter.ac.uk/igov/enabling-the-transformation-of-the-energy-system/>

⁶ <http://projects.exeter.ac.uk/igov/getting-energy-governance-right-lessons-from-igov/>

⁷ *ibid*

⁸ <http://projects.exeter.ac.uk/igov/electricity-market-design-5-summary-of-blog-series/>

(both energy and system services)⁹; and filling the local distribution governance gap (including with local authorities)¹⁰.

The draft determination cannot, of course, cover all of this. Local governance and filling the distribution gap requires multiple government departments to be involved as well as local authorities and other stakeholders etc. Really active distribution service providers (DSPs) (heat and electricity) cannot exist without that filled in distribution governance gap. A really active independent and integrated system operator (IISO) cannot exist without really active DSPs, and without changes from the ESO to an IISO. Ensuring this institutional governance is in place is the Government's responsibility. The first step forward to sorting this out is for the Government to establish an Energy Transformation Commission.

Only then can incentives really be put in place to be cost effective in delivering the outcomes set out in this draft determination.

Section 3

What is good about this Draft Determination?

Given the points raised in Section 2, it is hard for Ofgem to deliver very much in terms of stated outcomes without parallel institutional and legal changes. However, as said above in the Introduction, there is much of value within this consultation document. I am pleased that there is a greater focus on net zero. I like the increased emphasis on the centrality of consumers and the discussion to genuinely involve them more in decisions.

I liked the setting out of the building blocks of the price control (page 14). I do not think these building blocks are sufficient; they will not get the energy system to net zero; nor deliver innovation on the scale necessary. Nevertheless, I think the breaking down of the different aspects is a valuable attempt to be more progressive. The necessary institutional and coordinating requirements could have been added in to the table, making the point that Ofgem is unable to make these changes themselves.

Similarly, the new approach of uncertainty mechanisms, especially the reopeners (eg page 56) reminds me of the attempts made in New York¹¹ to stimulate innovation. Again, I don't think the incentives as set out in the document are sufficient, and it also needs parallel institutional and policy change. Nevertheless, the idea for example that approximately 50% of baseline (page 19) links to uncertainty mechanisms and PCDs is a welcome step forward.

Section 4

What could Ofgem have done better in this Draft Determination?

It seems to me that much of this Draft Determination is either dealing with unknowns (and not Ofgem's fault), and therefore unhelpfully untargeted (ie in relation to the fossil gas network / hydrogen) or wasted effort (for example, it is setting out the ESO's incentives for 2 years (2021-2023). One hopes at that point, the ESO is turned into an independent system operator; joined with

⁹ <http://projects.exeter.ac.uk/igov/getting-energy-governance-right-lessons-from-igov/>

¹⁰ <http://projects.exeter.ac.uk/igov/new-thinking-governance-for-local-energy-transformations/>

¹¹ <http://projects.exeter.ac.uk/igov/primer-new-york-state-rev/>

heat; and incorporating code managers, as IGov argues for. Surely far better to go straight to the independent system operator now.

However, Ofgem is in the place it is. I have said elsewhere I would have hoped that Ofgem is far more vocal and transparent about how its Duties are inappropriate for its role. There was again no mention of this in the report. The decisions which Ofgem takes continues to make the decision lag in the energy system greater (see Figure 1 below). Regulation (ie Ofgem) is lagging what is required more and more. The relationship between BEIS and Ofgem has to alter; and Ofgem's role and its Duties have to change if we are to be able to get the necessary regulation / incentives we need.



Figure 1 The Decision Lag from Ofgem's Decisions is Increasing

Given the place Ofgem is in, it is unfortunate that Ofgem has chosen to cut the rate of return so substantially for the ESO without giving it sufficient incentives to turn it into a truly enabling SO (the blue square in Figure 2 below). The idea of Figure 2 (please excuse hand drawn figure) is that the regulation of the ESO / IISO is very special and should be different from current network regulation. Ofgem has to establish incentives so that the ESO / IISO enables a hugely more valuable set of energy system services beyond its own capital assets.

My own view is that it is not a bad regulatory outcome when companies make a good return on their assets if they are doing a good job. It seems to me that the argument put forward by the draft determination to cut the ESO's return whilst also not giving it appropriate incentives is undermining the ESO / IISO's development into the large blue square below, which is detrimental to customers and to the move in Britain to a smart and flexible energy system. I strongly urge Ofgem to rethink the incentivisation of the ESO.

In different ways, the RIIO2 draft determinations on the incentives of transmission and gas distribution is also too early. It is vital for net zero that we know what we think we are doing with the fossil gas networks. We have to stop using fossil gas rapidly. There is no place for hydrogen in domestic heat. Why therefore are consumers being asked, without seemingly any questions in this

draft determination, to continue with fossil gas networks and unspecified hydrogen usage? In addition, how we incentivise transmission depends on what we do with the ESO and what happens to DNOs.

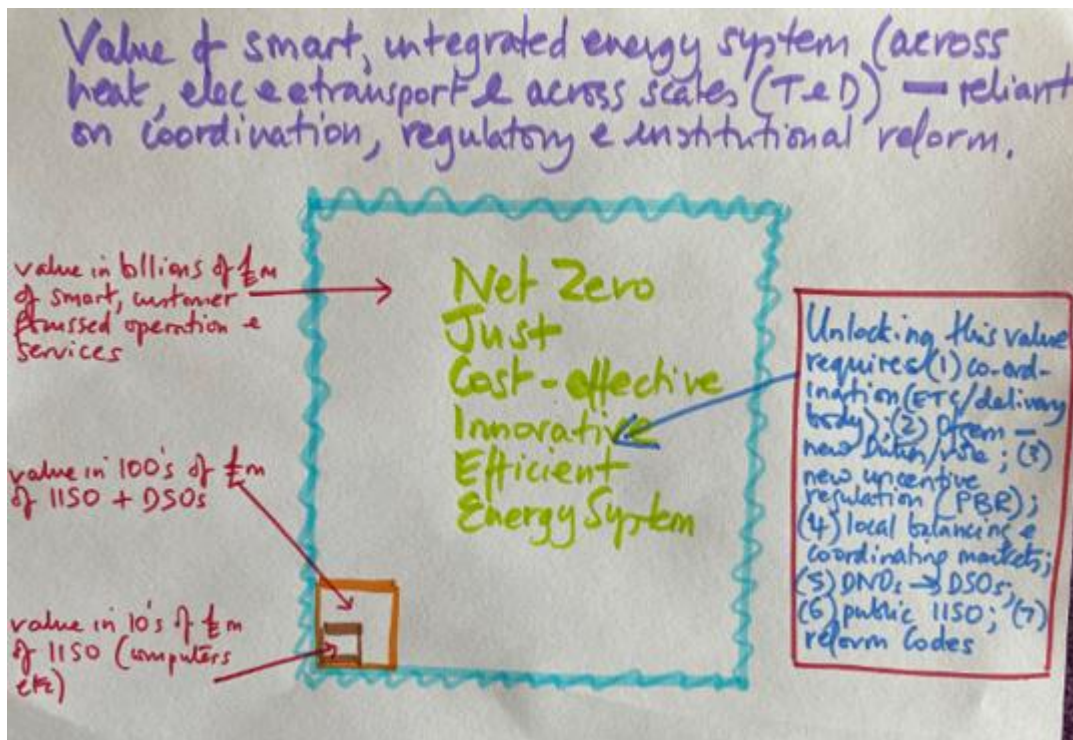


Figure 2 – differing service values enabled by different incentive schemes on the IISO

Conclusion

RIO is incredibly important to Britain in many ways. However, without institutional and policy reform, it will at best not make matters worse – but will not deliver innovation and net zero – or it may (in my view more likely) make matters worse.

This note may appear unhelpful. The main practical point is to argue for Ofgem not to put in place incentives on the ESO which keep it to the brown square in Figure 2 (as currently seem to be the situation in this determination).

It is hard to take big decisions – particularly when there appears to be no guidance from Government that it would be welcomed. But Ofgem is in a 'new' place with a 'new' Chief Executive. Now is the time to try and make a shift change in our energy governance for the benefit of customers and, more broadly, UK plc.

Professor Catherine Mitchell

