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Jonathan Brearley
Chief Executive Officer
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Dear Jonathan,

Ofgem's Forward Work Programme 2021/22

We very much welcome the opportunity to respond to the consultation on Ofgem's 2021/22 *Forward Work Programme*, which comes at a pivotal time in thinking about the future of energy systems and regulation. We are very keen to work constructively and collaboratively with you in the delivery of your three core priorities of: protecting consumers, especially the vulnerable; decarbonising to deliver a net-zero economy at the lowest cost; and enabling competition and innovation, which helps to drive down prices.

The overarching framework for the *Forward Work Programme* seems very sensible although as an aside it is a little hard to navigate given the mix of three core priorities; having two enduring priorities (i.e. core regulatory functions and the delivery of current and new government schemes to support vulnerable consumers and advance decarbonisation); and then five strategic change programmes. Nevertheless, we are very supportive of the overall direction of travel you are undertaking.

Our comments, as a gas distribution network (GDN), are largely confined to the issues that pertain to the regulation of gas networks, which is critical to successfully meeting these objectives.

Ofgem has identified a good number of the areas that need to be focused on in 2021/22. We believe, however, that there is significant work and thinking to be done on three interconnected areas, which perhaps need greater amplification in your *Forward Work Programme*:

1. How the evolution of the gas industry is likely to occur alongside the electricity sector (which has perhaps had much greater focus from Ofgem in recent times - and to some extent is still reflected in Ofgem's proposed plan).
2. How regulation of networks is going to occur between price reviews.
3. The shape of RIIO-3 and future regulation to support Net Zero.

We believe this work should be complimented by a thorough RIIO-2 lessons learned exercise. RIIO-2 has seen a considerable shift from the conclusions of the RPI-X@20 project, which introduced the RIIO regime, and we believe there is value in taking stock of what the focus of the regime needs to be going forward as well as how the price control is undertaken itself.



The future of gas

There remains a good deal of work to do to understand the likely pathways for the energy sector towards Net Zero. This will help to shape and support the role the gas industry must play in Net Zero transition and to prepare for RIIO-GD3. The next year will be a critical time to make real progress in defining the role that hydrogen may play in the future energy transition, and to consider and develop the regulatory and industry mechanisms that will be needed to enable this option for customers. We welcome some of the flexible mechanisms that have been developed in the RIIO-2 framework and we expect there to be a real need to work closely with Ofgem on utilising these mechanisms to develop the hydrogen and clean gas options rapidly over the next year given the increasing interest in this pathway.

We are committed to leading the industry as it prepares for the transition to Net Zero. For example:

- Our HyDeploy project is exploring the feasibility of blending hydrogen with natural gas.
- We are now preparing for HyNet North West, which will establish a low-carbon hydrogen exemplar cluster.
- Our Future Billing Methodology project looks at how the industry systems may need to develop to enable different clean gas technologies

All of these projects are moving into exciting new phases which will shape the future regulatory and industry frameworks and we are keen that Ofgem are fully involved in discussions on their development.

Regulation between price reviews

We are supportive of the move that is being made to a more 'adaptive' form of regulation, where everything is not merely left until there is a big set-piece price review every five years or so.

We have worked closely with Ofgem on the mechanisms that have been put in place at RIIO-2 where Ofgem listened to, and acted upon, several concerns that the GDNs raised through the process. This has created a range of adaptive mechanisms that can be used within the price control to respond to the changing external environment.

For any mechanisms of this kind to work effectively there will need to be 'nimbleness' in their application. We would not envisage an extended and prolonged process like I have experienced in water for the interim determination of K (so-called IDOK) mechanisms which took the form of 'mini price reviews'. In this case this would not be to customers' benefit as necessary investment might well be delayed.

It is important to link this work to the fourth of the strategic change priorities: transforming Ofgem where for such mechanisms to work as intended there may well be a need for different skills and behaviours.

Delivering a successful RIIO-3

Given RIIO-2 will only last for five years there is a need to consider when the work for RIIO-3 needs to commence. By way of illustration, Ofgem commenced the RIIO-2 process by publishing an open letter 45 months before the start of the new price control period. If Ofgem follows the same approach for RIIO-GD3, it will need to publish an open letter for the next price control in the summer of 2022. We consider that the industry and Ofgem should use the next 18 months to frame the content of that open letter and we are keen to work with Ofgem to develop the scope and focus for RIIO-3

The importance of commencing work on the RIIO-3 price control in the next 18 months is underlined by the very wide range of policy and regulatory issues that need to be addressed as the gas industry prepares for Net Zero. For example, Ofgem will need to consider:

- **The overarching aims of each price control period** - it is important to consider what RIIO-3 will need to deliver to ensure the UK is on the right path to Net Zero. This will require a 'future back' longer-term perspective on RIIO-3 in particular.
- **Preparing for Hydrogen and the decarbonisation of heat** – where most commentators consider that hydrogen is very likely to play a key role in the transition to net zero. Moreover, the government is set to make important decisions on heat policy. Both developments will have profound implications for the gas distribution businesses.



For example, a lot of work is required to create the right industry and regulatory framework to enable the possibility of a transition to hydrogen. Industrial hydrogen clusters, such as Hynet, provide an excellent opportunity to trial the role that hydrogen can play in the energy mix. We would encourage Ofgem to consider how the regulatory framework should be adapted for hydrogen and Government's emerging heat policy.

- **System operator (SO) separation** – Ofgem has signalled that it would like to see the electricity and gas system operators combined into an independent organisation. We observe that, whilst significant work has been undertaken on the establishment of an independent electricity system operator, relatively little work has been undertaken on the establishment of an independent gas system operator. This work needs to progress with urgency if a full separation is to be delivered in a timely way. An important element of this work should be a consideration of the relationship between an independent gas system operator and the gas distribution networks.
- **The extent and goals from incentivisation** - RIIO-2 has seen a significant constraining of *ex ante* incentives and a move to more *ex post* regulation with a tight and granular control of inputs and outputs. We need to consider what customers will need in the next phase of the Net Zero transition, what outputs they will value and how best to incentivise the right outcomes for consumers and society.
- **Benchmarking efficiency** – The RIIO-2 process has highlighted the difficulties associated with benchmarking gas distribution business costs. By its nature, benchmarking work is technically complex, and it is often easy to draw the wrong conclusions from the data and supporting analysis. We think there are strong arguments to commence working on benchmarking well in advance of RIIO-3 to ensure we are identifying the right level of costs to support current and future consumers.
- **How to strike the right balance and simplify the controls** - We consider that more work is needed to simplify the RIIO price controls. We also think that work is needed to ensure regulation strike the right balance between securing a fair outcome for customers whilst still incentivising companies to deliver better and more innovative services, maintain world class levels of safety and reliability - and of course deliver Net Zero.
- **The role played by customer engagement** – During the development of their RIIO-2 business plans, the gas industry devoted considerable effort to engaging with customers and other stakeholders. Cadent invested significantly in these activities, through over one million interactions and insights, and established a strong Customer Engagement Group that robustly challenged our plans and set the benchmark for the industry. Given Ofgem is the ultimate arbiter on the price control, we believe there is a need to evolve these arrangements such that customer engagement groups are less about fulfilling a regulatory role and more about providing expert customer insight and collaboration to drive better customer outcomes from companies' plans. With this intent we have established a 'critical friends' panel which looks to evolve the independent challenge group role and focus on the key challenges facing networks and customers in the future. We will feed our views into Ofgem's upcoming review of the customer engagement processes.

Playing our part

There is a great deal of work to be done to ensure that the regulatory framework develops in a way that delivers for customers, whilst delivering Net Zero. We will be bringing forward our own ideas on all the topics and are keen to start a conversation with Ofgem and the industry to help shape the future gas sector for our customers and stakeholders.

Please do not hesitate to reach out to us on any of the things covered in this note.

Yours sincerely,

Dr Tony Ballance

Chief Strategy & Regulation Officer

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