

## ENERGY NETWORKS ASSOCIATION RESPONSE TO OFGEM CONSULTATION ON RIIO-ED2 SECTOR SPECIFIC METHODOLOGY CONSULTATION

### Introduction

1. Energy Networks Association (ENA) represents the companies that operate and maintain the gas and electricity grid network in the UK and Ireland. Serving over 30 million customers, they are responsible for the transmission and distribution network of 'wires and pipes' that keep our lights on, our homes warm and our businesses running.
  - 1.1 The strong track record of our energy networks since privatisation in 1990 in improving services and lowering costs is key to understanding the role that they can play in the future. Continued high quality and efficiently delivered energy networks services are essential for both consumers and to help the government meet its short, medium and long-term objectives for energy policy.
  - 1.2 Our energy networks are recognised around the world for their strong track record of safely and securely providing the UK with the heat and power it needs underpinned by three key areas.
    - I. *Trusted performance.* Since privatisation customers have 59% fewer power cuts while their length has been reduced by 84%. Since 2010 DNOs have collectively<sup>1</sup> reduced the number of customer interruptions by 36%; reduced the duration of customer interruptions by 46%; reduced the electricity distribution part of the bill by 32%; increased customer satisfaction scores to an industry average of 90%<sup>2</sup>; and connected over 1 million distributed energy resources that are predominantly low carbon.
    - II. *Reduced costs and increased investment.* Network costs are now 17% lower than they were at the time of privatisation and are projected to remain flat, and in some areas fall, into the next decade. The UK's energy networks have attracted over £100 billion of investment since 1990. A significant proportion of which is spent with UK companies. New investment in the networks is forecast at £45bn between 2017 and 2023.
    - III. *Strong innovation.* Independent research carried out by Pöyry for Ofgem has shown that innovation projects by electricity Distribution Network Operators (DNOs) could deliver up to £1.7bn of benefits by 2031.

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<sup>1</sup> The data for these statistics comes from Electricity Distribution Company Performance reports published by Ofgem

<sup>2</sup> Since the introduction of the Broad Measure of Customer Satisfaction in 2012-13

- 1.3 We welcome the opportunity to respond to the RIIO ED-2 Sector Specific Methodology Consultation on behalf of our members. This response sets out a collective view of key common principles and areas of focus for ENA representing the Electricity Distribution Operators (DNO's). Our members operate long-term asset businesses so it is clear to them that meeting consumer needs and enabling government policy is at the heart of how they succeed. ENA consider that the RIIO-ED2 methodology must be consistent with and facilitate these objectives.

### **Context – Challenges facing the UK**

2. The UK faces a number of uncertainties and challenges over the period of the next price controls for gas and electricity networks. These are many and include the need to drive rapid recovery from the impacts of COVID-19, to continue to decarbonise our energy system on the journey to meeting Net Zero and to respond and adapt to potential impacts of leaving the EU.
- 2.1 In modern times there has never been greater need than now to create the conditions for a robust and growing economy that enables opportunities to be captured and exploited fully for the benefit of all, including vulnerable consumers. The RIIO-2 Price Controls and the decisions made as part of them by the regulator will have a major influence on our future energy system and the wider economy that it serves. **It is therefore imperative that the approach for RIIO-ED2 is not considered in isolation, but in this wider context being explicitly recognised as part of a wider strategy for delivering investment, clean growth and meeting consumer needs.**

### **Networks central to a Green Recovery and Future Economic Growth**

- 2.2 Government's objectives are clear in that it wants to encourage, and support, initiatives designed to boost economic growth and productivity by backing businesses to create jobs through investment in skills, industries and infrastructure. Ensuring an affordable and reliable energy supply for businesses and consumers, is central to these objectives and protecting the climate and environment upon which we and future generations depend.
- 2.3 The UK has been at the forefront of encouraging the world to move towards clean growth and the government is committed to ensuring the UK is able to continue the move towards a less carbon-reliant economy with the adoption of 'clean' technologies across the economy. In doing so it seeks to maximise the advantages to UK industry from the global shift to clean growth, by leading the world in the development, manufacture and application of low carbon technologies, systems and services.
- 2.4 Energy networks are the arteries of our economy and their defining characteristics of world-leading levels of safety, reliability, efficiency and carbon reduction, with a strong consumer focus, must be maintained if we are to seize opportunities and realise associated benefits. **It is therefore critical the ED-2 methodology creates the conditions to attract levels of investment in our networks needed to deliver these strategic goals.**

## Protecting vulnerable consumers

- 2.5 Britain's energy networks have an excellent track record of customer service and provide additional support for those members of the public who may struggle with energy bills or be more vulnerable in the case of an incident. Our members welcome the focus on households in vulnerable circumstances under RIIO2 and believe they are well placed to continue to deliver real benefits to this group of consumers.
- 2.6 More than six million people are enlisted on the Priority Services Register (PSR), a free service run by DNOs for customers in need. Services under the PSR include advance notice of planned power cuts, priority support from DNOs in an emergency, alternative heating and cooking facilities, keeping friends and relatives updated, and in certain scenarios free hotel overnight stays with transport to and from accommodation included. Meanwhile, GDNs have worked with DNOs to store and share data across the energy sector to ensure that the companies have the best data available to provide the services for PSR customers.

## Delivering a Smart Low-Carbon Whole Energy System

- 2.7 Smart systems transform our ability to use clean energy cost effectively so will be in high demand globally. The GB network companies are at the forefront of the smart transformation that is already well underway and increasingly gathering pace. The changes to the way in which we design, build and operate our gas and electricity networks will support and enable the introduction, development and scaling up of low-carbon technologies and systems that will deliver reliable and affordable low-carbon energy to our homes and businesses.
- 2.8 The government recognises the world leading capability of our energy networks and the benefits that are already being realised through the transition to a smarter, more flexible network. Building on this, stakeholders across all areas of energy production, transportation, supply and consumption are driving forward new and innovative initiatives to deliver the continued transformation of our energy system.
- 2.9 Our members believe the greatest efficiencies in delivering a secure, low-carbon sustainable energy system will be realised through the adoption of a 'whole system' approach. For us a whole system approach means looking at optimal network investment and operational decisions for the whole energy network (such as across the traditional distribution-transmission divide), not just the individual parts in isolation. It also means considering interactions across energy vectors (e.g. power, energy storage, transportation and heat networks) so that wider options and consumer value can be taken into account. **It is essential the RIIO-ED2 methodology supports these government and consumer goals.**

## RIIO-1

- 2.10 Network regulation under RIIO-1 has been a success story for consumers with network costs reducing and service to customers improving as recognised by the CEPA review of RIIO-1. We believe the framework for network regulation is working well, incentivising companies to improve, and so future developments for RIIO-ED2 should be built around similar objectives and goals to the RIIO-1 framework as these are customer and stakeholder focussed, and are now understood and trusted by investors.

- 2.11 This approach is most likely to continue the success of the UK's energy networks in attracting investment, reducing consumer costs and delivering new sources of low carbon energy. Incentive regulation in Great Britain is widely recognised as being very effective whilst network companies continue to deliver world class service quality. Eurostat datasets show that GB network costs for both domestic and industrial consumers are lower than or comparable with other major EU economies (Germany, France & Italy). Service standards have improved markedly under the price control framework since privatisation in 1990, with the RIIO framework recognised as an exemplar and replicated across other jurisdictions.

### **Response on specific aspects of the ED-2 methodology**

3. In the remainder of this response, we comment on a number of key areas of the RIIO-ED2 methodology proposals, with these grouped under broad themes consistent with the structure of the consultation document.

### **Innovation and incentives**

- 3.1 Innovation and incentives have been central to the successes achieved for customers in RIIO-ED1. We therefore urge Ofgem to continue to apply the principles of incentive-based regulation and strongly believe that applying these principles to the design of the framework will deliver the transformational changes needed to deliver Net Zero.
- 3.2 It is generally recognised that RIIO is world leading and has delivered significant benefit to customers. Core to this is the focus the framework gives towards enabling management teams to implement business change that leads to strong operational performance improvements. Therefore, whilst there is scope to debate incentive rates, there should be no doubt that incentive based regulation, utilising clear and strong incentive mechanisms that drive BAU innovation and benchmarks performance across companies is in the interests of customers. Consistent with this aim, the incentive package needs to be symmetric and offer genuine opportunities to reward companies for driving improvements in services for customers. Maintaining a strong Totex Incentive Mechanism (TIM) sharing factor will be crucial to continue driving efficiencies and innovations as part of business as usual (BaU).

### **Net Zero and Innovation**

#### **Common planning scenario**

- 3.3 Given the uncertainties around the exact pathway to Net Zero, the RIIO-ED2 framework will need to respond quickly to change, including new information, developments and customer and stakeholder needs. Business plans need to be able to reflect the specific local and regional targets set by company customers and stakeholders, enabling the pace of decarbonisation consistent with the ambition set by regional elected representatives in the devolved and regional governments.
- 3.4 Since the RIIO-GD2/T2 submissions, the ENA Open Networks project (WS1B, Product 2) have been working on improving standardisation across company forecasts by developing an 'Initial alignment and feedback' approach. This is where all companies use the ESO's Future Energy Scenarios as a starting point by using a common scenario framework with common building blocks to ensure consistency. This enables DNOs to reflect regional requirements and feed-back the changes they have made into the GB level ESO FES on an

annual basis. This will help more accurately understand and recognise local and regional differences whilst refining the GB level forecasts.

#### Uncertainty mechanisms

- 3.5 Whilst we in principle support the appropriate use of uncertainty mechanisms, being an important option in the RIIO toolkit, these should be used in a targeted and transparent way, that apportions risk to the party best able to carry that risk, with any approach applied for RIIO-ED2 designed so as to avoid creating undue delay and/or additional costs.
- 3.6 In considering any approach we draw Ofgem's attention to the characteristics of distribution networks and the typical relatively low value of projects which lends itself well to the use of automatic type mechanisms (with suitable thresholds) together with ex-ante allowances. This would provide a transparent, stable and predictable approach that can respond quickly to consumers' changing needs. As well as mechanisms that are already common to all DNOs, Ofgem should also recognise where there is a need for bespoke approaches will support these objectives.
- 3.7 Further joint work can ensure that there is a good and common understanding of how the mechanisms will work together as a package and to flesh out the details in time for the final methodology being published. Ultimately, this will ensure accurate and ambitious business plans can be submitted with knowledge of the triggers and thresholds for each mechanism. Not every detail has to be set in stone though at SSMD stage, as follow on work will be needed. The timetable and approach for follow on work should be set out in the SSMD.
- 3.8 We therefore look forward to working together with Ofgem to design a framework that best allocates risks while enabling networks to play the fullest role in decarbonisation and meeting the needs of consumers.

#### Advisory Groups

- 3.9 Further information is needed on the role and responsibilities of the new Net Zero Advisory Group and the Net Zero Innovation Board. Of particular importance is the need for networks to be able to directly engage with these groups in order to ensure that their advice is fully informed with all perspectives. This is needed to support a joined up approach across government policy and serve to inform the decisions of the regulator in setting the framework for RIIO-ED2 and any decisions throughout. We look forward to further detail on the role, remit and future agenda for these advisory groups and would welcome any opportunity to engage with them going forward.

#### Strategic Investment

- 3.10 Ofgem will need to design a framework that enables DNOs to proactively facilitate projects that are of strategic importance by establishing a new assessment framework, whether this is driven by central or local government.
- 3.11 Future strategic type investments, whilst recognised as being necessary, needs to be well justified and supported by a risk and uncertainty analysis, which both reveals a low risk of asset stranding alongside a high confidence of benefits for customers.

- 3.12 Mechanisms can be designed to ensure that DNO interventions are accurately tracked, timely and cost efficient in terms of cost and future needs. For example, volume drivers, should provide DNOs with sufficient flexibility to deal with much of the demand related uncertainty during the RIIO-ED2 period. In addition to this, Price Control Deliverables (PCD) could be proposed by DNOs where there is a high confidence that discrete investments are needed to support specific customers' needs and providing the PCD framework enables sufficient flexibility in delivery.

### **Transition to DSO and Data**

- 3.13 The ENA's Open Networks Project is a world leading major energy industry initiative that will transform the way our energy networks work, underpinning the delivery of the smart grid. Through Open Networks DNOs are driving the transition towards DSO in RIIO-ED2 and to continue to do so will require Ofgem to set a regulatory framework that supports the shared DSO goals.
- 3.14 It is important to recognise that the ESO function cannot simply be replicated in DSOs and ED2 is a period of continued transition and learning and that the differences in network topography and user needs is likely to require different approaches on differing scales, with these tuned to the specific regional/local conditions.
- 3.15 It is important that DNOs can continue to deliver their core services which underpin the transition to DSO in ED2 and the framework should not lose sight of this. ED2 is not time to consider separation, ED3 should review delivery, fully informed by the learning in ED2.
- 3.16 Particularly with respect to DSO, data and use of data is key and we agree this is a key enabler in a changing energy environment. DNO's are making substantial progress in making more of their data open and continue to support the principles and recommendations of the Energy Data Task Force (EDTF) and associated working groups, as well as actively readying themselves as part of our preparations for RIIO-ED2.

### **Finance – Enabling investment**

- 3.17 In order to assist in the development of a sound evidence base to inform decision makers, networks, wider stakeholders and the engagement and decision-making process, ENA has commissioned a number of leading independent economic experts to undertake appraisals of the methodologies proposed by Ofgem for determining a number of the key financial parameters for RIIO-2. This has been provided to Ofgem as part of ENA's response to the RIIO-2 GD/T2 Draft Determinations.
- 3.18 We again draw Ofgem's attention to its proposals for an outperformance equity adjustment and Returns Adjustment Mechanism (RAM) which we do not think is necessary in a well calibrated price control.

### **Expected vs Allowed Returns (downward adjustment to the allowed cost of equity)**

- 3.19 We do not agree with Ofgem's proposal to make any downward adjustment to the allowed cost of equity to reflect its expectations that companies will outperform the targets that it sets at these price control reviews. We believe this is an adjustment which is conceptually and practically flawed.

- 3.20 ENA commissioned independent authoritative experts Frontier Economics to review Ofgem's proposed approach. Frontier's report '*Further comment on Ofgem's proposal to adjust baseline allowed returns*' is submitted as part of this response.
- 3.21 Analysis carried out by Frontier shows that the proposal to adopt an outperformance wedge is flawed owing to the raft of negative effects that it will have on the wider regulatory framework and the harmful consequences for incentives.

#### Returns Adjustment Mechanism (RAM)

- 3.22 Whilst we understand the underlying rationale for the use of a RAM, it is nevertheless a fundamental principle of an incentive-based price control that outperformance should be encouraged, not penalised. If employed the design and calibration of a RAM needs to be considered carefully to ensure there are no unintended consequences such as a reduction in value for money that would flow from reduced incentives to innovate and improve performance.
- 3.23 We therefore look to work together with Ofgem in the design of an appropriate RAM should it conclude necessary. .
- 3.24 We would ask that Ofgem consider this evidence under his section or our response carefully in the context of ED2 whilst also recognising the need to consider the specific characteristics of electricity distribution networks and the policy challenges they will be expected to meet, when determining certain aspects of the financial parameters for ED2.
- 3.25 Finally, the ENA is currently reviewing the CMA Provisional Findings and will be responding to this consultation on the 27<sup>th</sup> October.

#### **Business Plan Process [Incentive & Assessment]**

- 3.26 It is important that we learn lessons from the RIIO-GD/T2. The outcomes from the business planning assessment approach for these price controls should be reviewed.
- 3.27 Transparency is required in advance of business plan submission on the assessment framework Ofgem intends to use for evaluating company strategies, particularly where ex-post assessments will be used (e.g. connections, vulnerability and DSO strategies). Defining timely and clear assessment criteria as part of the business plan submission will align expectations between DNOs, Ofgem and wider stakeholders. Further consideration is also needed around how the proposals to introduce new baseline standards of performance for DNOs based on proposals put forward in another DNO Business Plans is aligned with stakeholder engagement and business planning timelines. Additional clarity is needed in respect of proposals to reset business plan minimum requirements, the process and the extent to which revised costs will be captured in business plans

3.28 Ofgem should consider how the Business Plan Incentive's design and implementation be taken forward, specifically:

- Stage 1 should genuinely be a minimum test: what is defined as "minimum" is not subsequently interpreted at an unreasonably high standard, for example one approaching best practice;
- Clarify how it judges Customer Value Propositions (CVPs) to help companies self-regulate for a more efficient process;
- Ensure CVP rewards, potential clawbacks and the ODI operate together to encourage both ambitious proposals and secure delivery. Reward and penalty arrangements should reflect both level of ambition and difficulty of delivery;
- Incorporate an in-the-round assessment, for example by scoring against specific criteria and use it to adjust CVP rewards. In any case there should be clarification on how rewards are to be scaled; Caps on the number and value of CVPs need more consideration; and need more consideration
- Clarity on the assessment process for high confidence costs (we observe that no gas distribution or transmission company was awarded any reward under this element in the GD/T draft determinations).

3.29 More generally, it would be helpful for Ofgem to publish more guidance on the BPI including the assessment process and Ofgem expectation, and evidence requirements. For example, what evidence Ofgem will accept from DNOs to move costs from low to high confidence or to justify the level of low confidence costs in a way which avoids BPI penalty, and what is the assessment process and eligibility criteria in relation to a Stage 4 reward.

3.30 In addition, how Ofgem will judge companies' customer and stakeholder engagement. For example, it could publish guidance on standards in line with regulatory practice from other sectors like water.

## Conclusions

4. ENA on behalf of its members welcomes the opportunity to respond to this consultation on the RIIO ED-2 Sector Specific Methodology. We reiterate our points regarding the success of RIIO-1, the experience and knowledge that is being gained in its application which supports evolutionary refinements to the existing RIIO 'tool kit' as the best way to deliver the right outcomes for consumers.
- 4.1 We strongly support Ofgem in seeking to set a framework that delivers a 'fair deal' for both consumers and investors. This means creating the conditions to attract new investment and drive behaviours that deliver network services that meet the needs and wants of a wide range of consumers consistent with advancing the UK's wider clean growth energy policy. We therefore caution against overly focusing on capping returns to investors regardless of levels of performance as this risks eroding incentives to invest, innovate and improve performance for customers. Especially when this is coupled with a move towards ex-post assessment of DNO performance, which further disincentives investment.

- 4.2 RIIO-ED2 needs to enable the electricity distribution networks to meet the future challenges of an uncertain investment and growth future, setting stretching targets whilst providing a stable regulatory regime in which investors can have confidence. This needs a holistic approach driven by objectivity and evidence.
- 4.3 Finally, we would like to acknowledge the level of engagement that Ofgem has undertaken in the RIIO-ED2 process to date. On behalf of our members we look forward to continued engagement with Ofgem over the coming months and beyond as we move into the business planning phase.
- 4.4 If you have any questions on the points raised in this response, please contact John Spurgeon, Head of Regulatory Policy, Energy Networks Association email: [john.spurgeon@energynetworks.org](mailto:john.spurgeon@energynetworks.org)

**Energy Networks Association**

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