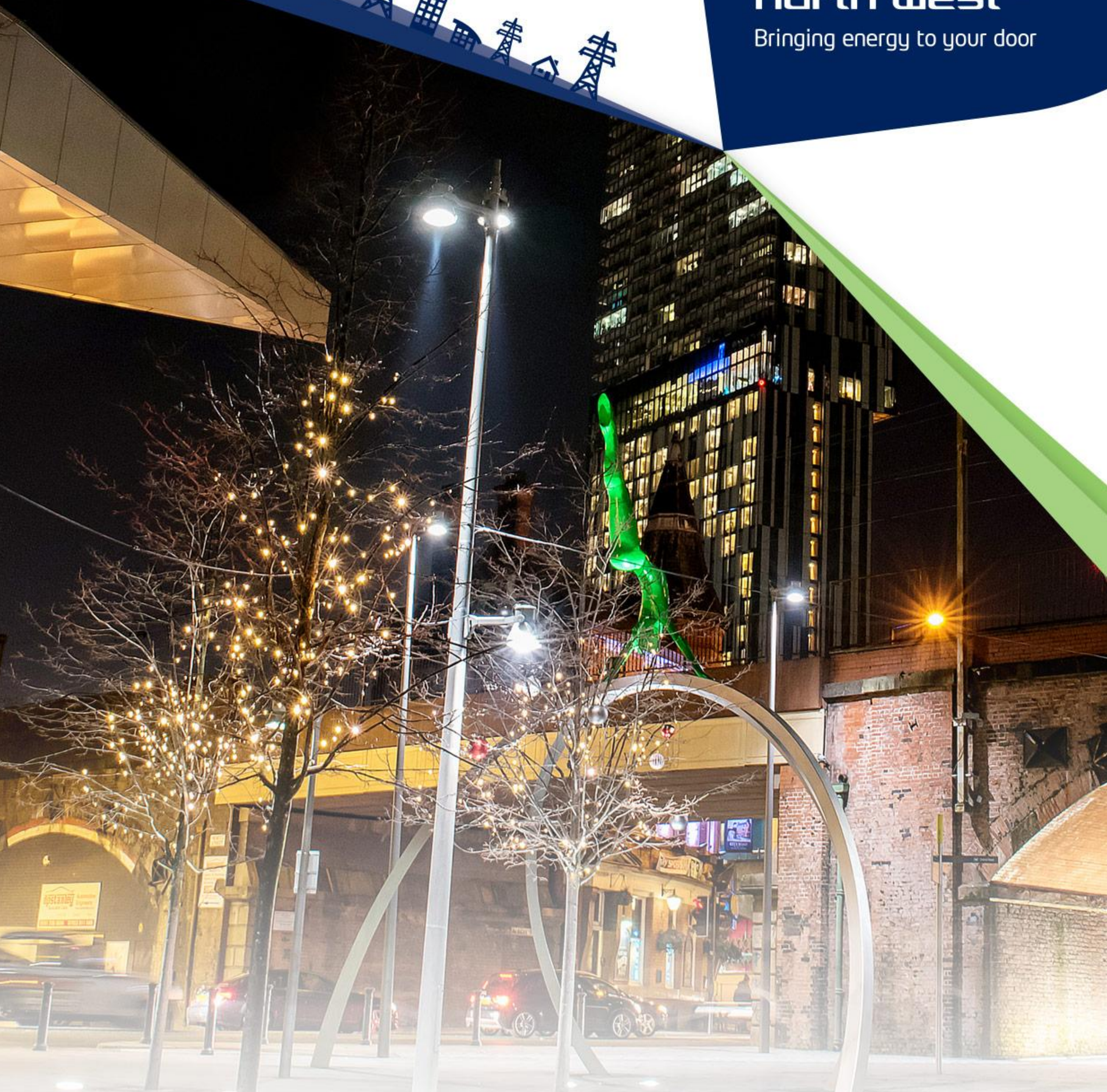
electricity north west
Bringing energy to your door



What does RIIO-2 need to deliver?

RIIO-2 Framework Consultation response – Appendix 2

1 Summary

As illustrated in Appendix 1, ENWL believes the RIIO framework is working for consumers in RIIO-ED1 in the form implemented for slow track electricity distribution networks with only a small number of areas where change is necessary, such as the cost of debt treatment. This shows the RIIO Framework itself is a sound basis for further development, with the risk being that substantial changes are made across a broad spectrum of issues when this is not merited. We believe the higher returns that are currently concerning for many stakeholders and challenge the legitimacy of the regime have arisen from how RIIO was implemented in the earlier price controls, in specific sub-sectors of the energy networks industry,and do not stem from the structure of the regime itself.

For example, hindsight now suggests that some investments by companies that were in baseline allowances were actually uncertain and should have been incorporated in an uncertainty mechanism with clear parameters as to what would happen to the allowance in the event that the associated output/s ceased to be required. These challenges can be addressed for RIIO-2 with the existing toolbox through the diligent application of current price control mechanisms. Much can be addressed through improved decision making regarding how risks are shared and funded and the assessment of what is in baselines, volume drivers or other types of uncertainty mechanisms. This can be done whilst ensuring incentives continue to be effective for companies to innovate and find ever more efficient ways of delivering. Incentives have been a highly successful feature of RIIO-ED1 driving better outcomes for customers such as reductions in power cuts and improvements in customer service and should be retained for RIIO-2.

2 Background

It is widely recognised that the energy sector is going through a period of significant change and electricity in particular is increasingly a central need for our customers to be able to run their lives. A report by the Royal Academy of Engineering looked at the very real implications of customers being without power in its report 'Living without electricity'[1]. This used the floods experienced in Lancaster during 2015 to provide a case study of the wide ranging impacts that power loss causes, from obvious loss of lighting, heating and cooking facilities to impact on communication networks, payment mechanisms and transport. As the contribution of electricity to people's lives increases then so do the ramifications of extreme events like the severe flooding and its consequential impacts.

In order to be able to continue to provide the reliable energy networks that customers have funded and companies have delivered in Great Britain (GB), continued investment into the sector is essential. Since privatisation of the gas and electricity networks, stable, low-risk, long-term, 'patient capital' has been successfully attracted into the United Kingdom (UK), with the stable regulatory environment often cited as a contributing factor to attracting this. Incremental evolution of the regulatory environment has allowed network operators to meet changing needs without causing concern to investors, resulting in significant benefits to customers in terms of cost reductions and a shift in the quality of service, in broad terms including much lower fault rates and higher customer satisfaction.

[1] https://www.raeng.org.uk/publications/reports/living-without-electricity

RIIO is the current and most innovative development in this regulatory regime after a stable period of RPI-X regulation. RIIO has been replicated to differing extents in other regimes as best practice for network regulation. Under the RIIO incentive regime, allowance has been made for all networks to succeed if they meet or exceed performance targets. This is powerful and effective as networks are not directly competing against each other, but largely to beat their own targets. This encourages collaboration which in turn is a driver for improvement, innovation and change that benefits customers across GB. Even within RIIO-1, there has been evolution so ED1 is quite different in its approach to T1 and GD1, taking the learning from these earlier cycles and demonstrating an increased maturity in its approach.

Given the change anticipated over the next decade, it seems appropriate that RIIO continues to evolve to reflect the environment it serves. In addition, increased political pressure is being brought to bear on the regulatory regime, reflecting the challenging economic conditions that continue to face the country. However, when considering a response to both these changes and the wider political environment, it is appropriate to ensure that the learning that has been captured in the ED1 arrangements is not overlooked and to distinguish between the different RIIO-1 arrangements when assessing how they are working.

DNOs are already at the forefront of the energy transition. The next years of accelerated change will be dominated by customer choice. Residential, Small and medium-sized enterprises (SMEs), Commercial and Industrial, Distributed Generation (DG), Storage, and new customers who have not yet emerged will all need to be served. The RIIO framework of Innovation, Incentives and Outputs provides a great basis for efficient and timely delivery without increasing costs or system risk. Ofgem should ensure that RIIO-2 maintains a level playing field for all current and future stakeholders.

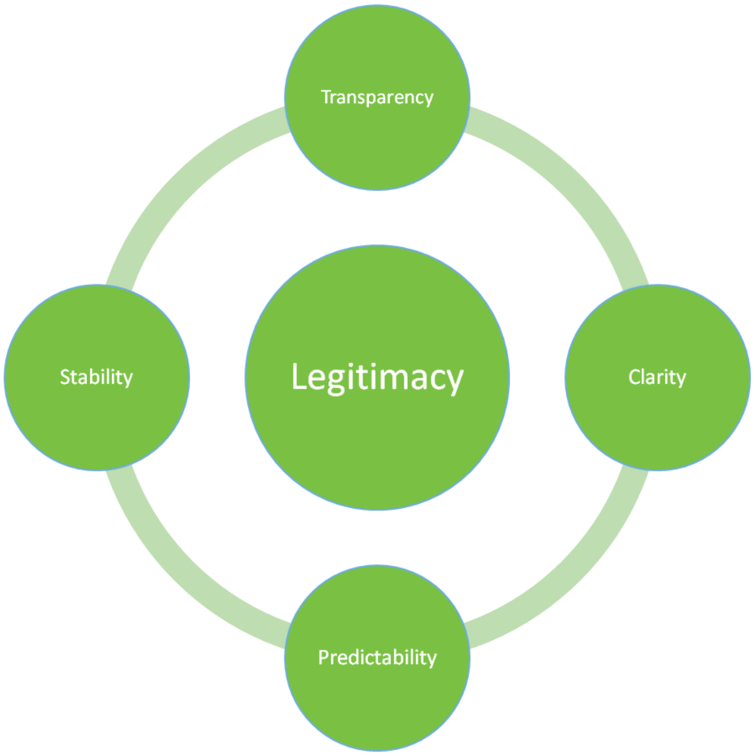
Further investment will continue to be required and it seems most likely that this will continue to take the form of further 'patient capital' as there are limited sources of capital prepared to be committed for such long periods of time with relatively modest levels of return. Increasingly, the market for such capital is global in nature and it is essential that the UK remains attractive to invest in, particularly when set against the wider political risks investors consider which have significantly heightened including, Brexit uncertainty, currency risk and potential nationalisation of network companies.

Regulatory stability matters at a time of increasing uncertainty in the UK market, now more than ever, to ensure networks continue to reeive the required investment provided by pension funds attracted to the sector by the liability matching and stability that it delivers. The well established investor confidence within the energy networks is based upon such continuity and stability and has been built over decades. Investors are comfortable with the evolution between price controls that 'reset' the baseline at the start of each price control period without undermining what shareholders believe they have invested in. Fundamental or wholesale changes to the Framework have the potential to raise investors' perception of risk and therefore must be very carefully considered to show how such shocks can be handled. Any significant change to the balance of risk between customers and companies, for example, has the potential to increase costs to customers if it increases the returns that investors like pension funds require. Short-term versus long-term economic pressures also need to be appropriately factored in as patient capital is by its very nature looking at a long time horizon, with a desire for stability.

It is also important to note that price controls can no longer look at averages or settlements 'in the round' since the introduction of the rules regarding any referral to the Competition and Markets Authority. If a settlement is challenged (and this is probably more likely since the ED1 precedent and range of parties that now can refer), then the CMA is likely to review individual components of the price control and on an individual licensee basis. Accordingly, price controls need to be considered on a component by component basis, looking at the specific circumstances of individual network companies. And, as customer groups are given an enhanced voice to influence and shape the arrangements for their locality, it also becomes essential that this is not undermined by a regulatory regime that imposes a centralised view or approach to a local issue.

3 What does RIIO-2 need to provide?

RIIO-2 should therefore mark a natural evolution of the regulatory regime, as observed in the slow-track ED2 arrangements, rather than a step change revolution. As set out in the ENWL response to the July 2017 Open Letter on the RIIO-2 Framework ENWL believes there are five key principles that the RIIO-2 Framework needs to address, namely Legitimacy, Transparency, Clarity, Predictability and Stability. These are shown in the following diagram and discussed further below.



Given the political pressure and scrutiny that is on the energy sector, it is essential that the RIIO-2 framework addresses the concerns about the **legitimacy** of the role networks play and the level of returns that it is appropriate for these organisations to make. Some of the legitimacy concerns can be addressed by moving to a basis of calculating returns that is realistic, taking actual company specific circumstances into account rather than basing calculated returns on unrepresentative assumptions. Some voices would like to push returns to an unsustainable low, but it is essential that Ofgem balances these voices against the level of risk that networks are being asked to bear, the investment required over the next decade, and the ramifications in the event that networks are unable to perform their essential role.

In considering this point, it is important to recognise that ED1 marked an evolution from the prior RIIO-1 controls and the additional checks and balances Ofgem included within this, particularly the slow-track settlements, delivered a more effective set of proposals. That the ED1 settlement was challenged by parties arguing it was both too generous and too tough illustrates that it was, at the time of the final determination, a finely balanced outcome which was then held up almost entirely by the CMA. Companies being able to drive out further efficiency does not mean that the settlement was wrong and actually shows how established the drive for efficiency and innovation within the sector has become, leading to long-term benefits for customers. Where further evolution is appropriate to reflect learning since the final determinations, this should be undertaken in a measured way to ensure that it does not result in an over-correction that might destabilise the regime.

The legitimacy of network returns would be further served by ensuring that all reporting is accurate. In particular, there are certain challenges associated with the calculation and reporting of Return on Regulatory Equity (RoRE) that have the potential to mislead. This is discussed further in response to Q45 and Q46 in Appendix 3. Prompt resolution of these challenges is essential.

It should also be noted that legitimacy is not the same as lower costs. It is about all parties being clear what the role and responsibilities of network companies are; that the returns companies are able to make are fair; and that the costs reflect what customers are willing to pay for. For example, as part of our work on ED1, we asked customers whether there were prepared to cover the costs to improve network investment for vulnerable customers at a small increase to their own charge. Our customers were clear that they saw this investment as being important and Ofgem agreed with this in finalising our allowances. Ensuring that feedback like this is acted upon is also important in increasing the legitimacy of network companies.

The importance of regulatory **stability** and certainty needs to inform the evolution. As described above, investors (predominantly funds looking for stable and long-term investments on behalf of pension funds and similar long-term savers) have looked to the UK's utilities as long-term and stable investments. Where change is needed, it needs to be tested against this to ensure that the proposals do not result in capital flight as it is unclear where alternative investment would ultimately come from.

Linked to stability is the need for **predictability**. Given the long-term nature of these investments and their role in funding liabilities like pensions, companies and investors need to be able to predict the impact of their performance on their allowed returns. Similarly, users of energy networks need to be able to predict the charges that they will face to inform their decision-making. Mechanisms that add uncertainty to the forecasting capability of networks should be used with caution as there may lead to unintended behavioural consequences.

To assist in the legitimacy debate, increased **transparency** around the essential role that networks play and how effectively this role is performed is a vital element of demonstrating how regulation is serving the customer. Ofgem and companies need to work with customers and stakeholders to understand how this message can be conveyed in a meaningful way and the current approach Ofgem uses to calculating company returns (RoRE) needs urgently revising so stakeholder views are informed by a more accurate and representative view of company performance.

Finally, the framework needs to promote **clarity**. This starts from the beginning with all stakeholders being clear about the process and their opportunities to feed into this, and goes all the way to the closeout of the price controls with clarity about exactly what networks are required to deliver. Mechanisms need to be finalised before the control periods start so real performance against outputs can be assessed across the whole period and companies are able to report transparently on their actual and anticipated performance, in terms of both costs and delivery.

4 Where is further thought needed?

Ofgem has clearly given thought to seeking to ensure the process is correct and is making a substantial effort to effectively engage with stakeholders. ENWL welcomes this. Overall work planning might need to be developed in more detail sooner as we are mindful of the available time and some tension as to what can be delivered in the respective stages of the RIIO-2 development as any proposals will need to be robustly evidenced. Indeed, it is essential that ambition for change is balanced against what can realistically be delivered in the timeframe to ensure that due process is not unintentionally sacrificed.

It is our view that the RIIO framework generally contains the correct measures and incentives and it is the calibration of these measures that requires improvement to award efficient performing companies, whilst also incentivising ongoing improvements and innovation.

A wide range of stakeholders have views on the future regulation of energy networks that need to be incorporated into this process. We already work with a wide range of customers, including householders, community energy schemes, academia, local authorities, housing associations, DG developers, storage developers, commercial entities, transport providers, and multi-national manufacturing companies, and expect this to increase as new entrants seek to engage with the existing and emerging opportunities in the energy sector.

In assessing and balancing the multitude of views, Ofgem need to be mindful that it does not inadvertently react to those stakeholders with the loudest voice. Destabilising the regulatory regime for relatively small short-term gains may seem attractive but the long-term ramifications of such an approach need to be fully understood and factored into the decision making process. In particular, Ofgem needs to be mindful that it does not inadvertently cause a dislocation in the fundamentals of utility regulation that diminish the attractiveness of investment in the sector for patient capital, particularly in electricity distribution that has not had the same levels of rewards seen in other sectors during the RIIO-1 controls and where returns vary between the ED1 settlements. An important factor in this will be robust Impact Assessments for the ranges of strategy and policy options being contemplated.

Ofgem also needs to be alert to the wider uncertainties that will influence the attractiveness (or otherwise) of investment into GB energy networks. Beyond any network specific industry uncertainties which we have addressed, there is the impact of Brexit driven changes to the UK economy which have arguably increased the risk of investing in the UK. This has increased political uncertainty (and therefore regulatory uncertainty) and it has increased the volatility of the UK economy with potential impact on inflation, exchange rate and tax rates. Whilst such matters are not under Ofgem's control, they will impact on the appetite of investors (both UK and foreign based) to invest in patient capital, seeking steady but low returns. Ultimately, these uncertainties could significantly reduce returns or wipe them out altogether. These factors will change, probably over the next 10 years, as the economy responds to the transition period and then. To ensure investments in energy networks remains attractive, consideration needs to be given as to how the RIIO-2 Framework will respond to this macro-level uncertainty.

The stated desire to make the regime low risk and low return could work for many patient capital investors. However, Ofgem needs to consider the cumulative impact of its proposed changes and whether the overall picture has genuinely resulted in a lower level of risk for investors such as pension funds or whether the extent of the proposed changes is in reality quite a fundamental shift in utility regulation.

Much of the Framework is still focussed on regulating capital intensive activities. We anticipate that as we move forward, focus will increasingly shift to using existing assets more effectively to respond to changing customer needs and behaviours. It is essential that the Framework reflects and facilitates this.

Ultimately, it is in customers' interests to have a robust and well regarded regulatory regime as it provides the stable foundation for investment, attracts the best talent to spearhead the innovation needed to deliver the scale of change anticipated and ensures high levels of network reliability and customer service are maintained. ENWL looks forward to working with Ofgem as it develops its thinking and to contribute to the debate about how networks are effectively and efficiently regulated over the next decade.