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Dear Steve

**Open Letter - Initial engagement around development of a Net Zero reopener for the RIIO-2 price controls**

Thank you for the open letter recently issued on the subject of a Net Zero reopener for the RIIO-2 price controls.

Throughout the course of our continuous stakeholder engagement during RIIO-ED1, and as we continue to learn from our focussed ED2 engagement, it is clear that our customers and stakeholders are passionate about climate change and our environment. Our stakeholders tell us that they expect network companies to rise to the challenge that Net Zero brings and are looking to us to take a leading role in this area.

We are already seeing local stakeholders such as Greater Manchester Combined Authority (GMCA) committing to move at a more advanced pace than that set nationally, and we see it is imperative that we respond to these regional drivers. We see through the enhanced stakeholder approach set for RIIO-2 by Ofgem there is a need for companies to act upon such regional influence.

As such, we are already consulting with stakeholders and customers on the various pathways to Net Zero and the impacts each will have on ED2 costs and outputs. A key element of this is our Distribution Future Energy Scenarios (DFES) which is a highly stakeholder informed process which was first published by ENWL in 2018. The DFES process is now being further developed to bring greater standardisation across networks as part of the ENA's Open Networks project in which Ofgem participates. It is very clear that Net Zero needs to be at the heart of our business and our ED2 business plans informed by stakeholder and customer views.

We welcomed Ofgem's recent Decarbonisation Action Plan as an indicator of the commitment and understanding that Ofgem has and the emphasis it is placing on decarbonisation. We also welcome the need to ensure that the RIIO-2 framework can be flexible enough to accommodate company's plans and changes that may occur in a price control period. We continue to develop our plans, respond to local and national needs and technological advances that provide greater opportunities to deliver better outcomes for customers.

Given the RIIO-ED2 price control won't be finalised until 2022 as part of the draft and final determinations process, we expect that a high degree of clarity can be reached on Net Zero. This means a reopener becomes



a useful backstop measure for anything that wasn't foreseen or cannot wait for incorporation into the next price control.

The RIIO framework is well designed and flexible to meet these challenges. We are working with Ofgem, DNOs and other stakeholders to understand the uncertainties we face in ED2 and the most appropriate options available to manage these, ensuring the appropriate balance of risk between companies and customers. In particular, ENWL has worked with stakeholders on a capacity mechanism volume driver to ensure companies are able to respond to customers' needs as they emerge. We are also actively contributing to discussions on the cost benefit analysis approach and scenarios work ahead of ED2 which will mean the ED2 framework can be set by Ofgem to facilitate Net Zero aims whilst ensuring all Ofgem's objectives including long term value for money for consumers are achieved.

We therefore welcome the concept of a Net Zero reopener, as a backstop measure and are pleased to see this early engagement on such a vital issue. The mechanism should be designed to accommodate material changes driven by specified central or devolved government bodies in relation to Net Zero which are not known when the price control is set and for which other mechanisms are not suitable. We expect that this informal consultation will be the first in a series of opportunities to engage/consult on this as Ofgem's thinking develops and is informed by stakeholder input and look forward to the opportunity to provide input into further consultations on this aspect of the RIIO-2 framework.

To turn to answer the specific questions raised within your open letter:

*1. What types of event or change do you think should trigger the net zero reopener mechanism?*

We consider that the intent should be for ED2 that a well-set ex-ante settlement can be made in such a way that enables Net Zero and therefore the aim should be that the reopener is not triggered.

Framework design aspects such as the volume driver for capacity that ENWL have proposed (namely 'the capacity mechanism'), along with other well-designed and targeted uncertainty mechanisms will help make the price control robust for Net Zero. We would expect that these framework design and uncertainty mechanisms would be used in the first instance, with any Net Zero reopener only being utilised if these other framework elements do not suffice.

Our Distribution Future Energy Scenarios (DFES) is the leading view of the North West's electricity needs, put together with our stakeholders input along with a central outlook which offers key insights into what our ED2 business plan should deliver. The DFES is therefore a key input into ensuring our regulatory framework and specific ED2 price control settlement meets Net Zero needs at the right pace, for the region we serve.

We also recognise that Electricity Distribution has the benefit of time (i.e. Final Determinations in 2022) where policy and pathways may be clearer compared to Gas Distribution or Transmission which are to be settled much earlier. We therefore consider that this reopener proposal is possibly more needed and with greater likelihood of triggering for the earlier RIIO-2 price controls than for ED2.

We have conducted a high-level review of the heat reopener in the Gas Distribution sector and consider there is risk of duplication with this proposed Net Zero reopener as both are likely to have the same driver and could be triggered by a decision on government policy. There may also be an associated impact on electricity for any gas decision, and therefore we would suggest one reopener, with one set of rules across sectors could avoid complexity. Further detail could be established as Draft Determinations for GD2 move to Final Determinations.

We note Ofgem's initial thoughts that the trigger could be fairly broad and include changes in Ofgem's policy position as well as government and other changes relative to Net Zero. ENWL support a limited number of targeted uncertainty mechanisms that are well defined and are clear about what risk or uncertainty they are

to address in the ED2 period. We do not support macro or broad measures such as the mid-period review reopener that existed in ED1 but was not required. The broadness of the mechanism leads to a lack of clarity for companies and Ofgem about how and why these should be applied and assessed. Ofgem's mid period review impact assessment at the time<sup>1</sup> showed the risk cost of a broader scope reopener being applied was between 10 and 100bps (depending on scope) and consideration of this should be given when setting the cost of equity for RIIO-2. Its therefore very important the definition of the reopener is right at the start of the price control.

We would caution against setting any Net Zero mechanism with insufficiently defined parameters; these should be tightly set, targeted and linked only to those driven by change in government policy (either central or devolved), unforeseen breakthroughs in technology driving changes in consumer requirements or significant market driven changes leading to unforeseen lower LCT costs. Also, there needs to be a material financial threshold, and clarity that other measures in the price control do not already deal with the issue.

Hence the types of event that trigger the reopener need to be clearly listed and be material. Our initial list is:

- Legislation to convert heat from gas to heat from electricity either locally or nationally made
- Changes or new legislation for electrification of transport
- Material technology breakthroughs or other market led supply side drivers leading to significant changes in DFES for the remainder of the price control period
- Legislation having a material and direct impact upon the rollout of low carbon generation or low carbon technologies
- Legislation directly and materially impacting how electricity is used

## *2. What types of changes to licences do you think the net zero reopener mechanism should provide for?*

Changes to licences should be limited to introducing new core obligations which are driven by government policy changes, with associated output and revenue revisions made. We suggest that changes are limited to material changes to licence obligations, or PCDs where material is defined as a £m value at a level to avoid repeatedly triggering the reopener throughout the shorter ED2 price control. Such changes should be considered on a licensee by licensee basis.

Changes should not be made to existing incentive mechanisms and retrospective assessment or impact should be avoided.

If any Net Zero reopener changes effect anticipated incentive returns or take place part way through a project delivery which has been committed to over the ED2 price control, the spend committed at the point of the reopener should be properly rewarded as if the incentive were in place and/or the change had not taken place. This would ensure that companies are protected from undue commercial penalties where, for example, contracts had been awarded.

In setting the materiality threshold and how the reopener might work, the ED2 package in the round needs to be reviewed. In a lower return price control where there is potential for more of the allowances to be associated with specific PCDs there could be much less flexibility for companies to respond in ED2 as they have in ED1 to changing environments without rapid decision making by Ofgem to determine allowances and direct that companies can immediately update their tariffs to fund the obligations agreed.

Depending how the rest of the price control package is designed and taking into account that companies business plans will be tightly drawn and carefully set, Ofgem should consider whether the proposed Net Zero reopener should be an upwards only adjustment to allowed revenues for RIIO-ED2 licensees. Especially if as initially proposed by Ofgem that the reopener is only able to be triggered by Ofgem.

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<sup>1</sup>[https://www.ofgem.gov.uk/system/files/docs/2018/04/riio-ed1\\_mid-period\\_review\\_impact\\_assessment.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/04/riio-ed1_mid-period_review_impact_assessment.pdf)

In Ofgem proposing it is the only body that can trigger the reopener this can only be seen as increasing the risk investors face and is concerning because ED2 companies are committed to meeting decarbonisation needs of their customers and stakeholders. Companies work closely with a range of stakeholders, including local and national government as well as the communities in their regions so companies can bring these regional insights into the process. Ofgem may not be as connected to the needs of regions as companies operating in them. Should Ofgem maintain sole responsibility for triggering the reopener as currently proposed, companies could provide Ofgem with a brief annual report as part of their Strategic Performance Overview (SPO) identifying any key changes in legislation, regional policy or technology that would have a material effect on the DFES and identify any important evidence about this change they believe Ofgem should consider. Companies could provide an initial assessment of whether the evidence of change they have identified would be adequately addressed by the existing uncertainty mechanisms in the price control framework. This addendum to the SPO would be published and Ofgem would then consider this evidence and respond to it publicly.

*3. What process do you believe we should we follow under the net zero reopener to determine whether changes to companies' licences are needed (and, if so, to determine what should those changes be?)?*

The most critical process consideration for the Net Zero reopener is that Ofgem will need to be able to make material decisions much more rapidly than today's processes and based, relatively speaking on incomplete information compared to Ofgem's normal requirements for a complete and high standard of evidence. This will enable companies to react quickly to an emerging Net Zero need. We expect any need to act to enable Net Zero not already enabled within the price control mechanisms (such as by a capacity mechanism) to be both material and focussed upon meeting urgent customers and stakeholder needs.

Ofgem is clear that it considers a lower returns and lower risk price control to be the aim for RIIO-2, hence any Net Zero reopener will be reserved for actions that a company will not be able to commit to absent regulatory agreement, as to do so would be higher risk.

Additionally, companies may have significantly lower financial flexibility to respond rapidly to emergent needs so Ofgem will also need to ensure any Net Zero reopener is decided quickly and that there is a timely positive impact on the cash position of the company if further expenditure is required.

The target should be for Ofgem to make any decision and enable the company to appropriately adjust its revenues to meet any new cash expenditure needs within 3 months of the start of the process. These kinds of timescales might be what's needed to avoid regulation becoming a blocker to meeting customer needs, depending on the nature of the ED2 settlements put in place for networks. Ofgem may want to also consider whether an approach where some initial funding could be rapidly released on a no-regrets/no-hindsight risk basis to allow companies to mobilise to meet urgent customer and stakeholder needs where these arise with a short lead time if Ofgem needs more time to make any decision(s).

In order to manage regulatory burden, we would propose that a materiality threshold should be included, and such materiality should be relatively high in the context of the price control, but clearly financeable under a range of scenarios. Other uncertainty mechanism thresholds or reopeners should be considered separate to this and within part of the ED2 sector specific methodology work underway at present.

To manage uncertainty and resourcing, we propose that consideration be given to a notification point (annual window each November) whereby Ofgem provides notice of intent to trigger or not based on the evidence provided by companies within their SPO addendum as suggested in our response to question 2. If not triggered, that window is deemed closed until the following year. DFES processes run at least on an annual basis as they are today and could provide early warning to companies, Ofgem and stakeholders as to potential triggering of a Net Zero reopener. If notice is given, the process will start, with the intent to revise revenues

within three months, including resetting DUoS tariffs with effect from the next April with one month's notice. Companies should have clear guidance on what Ofgem requires and when to make decisions.

As well as Ofgem having predefined timescales for decision making, we suggest the framework also includes:

- If Ofgem does not make a decision within the specified time-limit and the company raised a change, the change should be treated as if it were approved by Ofgem;
- It should be drafted in such a way that Ofgem takes no account of the general financial performance of the licensee.

*4. Do you have any comments on the introduction of a net zero reopener as it may relate other uncertainty mechanisms and, do you think any changes are necessary to the design of those mechanisms? For example, the CAM, as mentioned above.*

It is crucial to ensure that each aspect of the RIIO-2 framework is complementary and there are no clashes or conflicts. Therefore, when developing the detailed design of any Net Zero reopener, it is important to first consider whether any other aspect of the framework is already able to manage such an event/situation, and how each may interact with the other. For this reason, the need for a Net Zero reopener and its definition should be drafted by Draft Determinations and not be finalised until Final Determinations. It may prove unnecessary to have the actual Net Zero reopener by the timing of Final Determinations or its scope may need to be updated.

In terms of the Co-ordinated Adjustment Mechanism (CAM), we consider that this is able to stand-alone, and do not envisage any situation whereby an application under CAM would need to trigger the Net Zero reopener however we do acknowledge that it is possible that use of the CAM may be triggered by a Net Zero driver.

How any Return Adjustment Mechanisms (RAM's) are implemented is also key. Any reopener funding for Net Zero would need to be adjusted for in how any RAM works. This broad point of reopeners and the function of RAM's is a general one though since a Net Zero reopener might be highly material, the concerns we have with how the mechanism works if RAM's are in place is important.

We agree that a very careful assessment of the interlinkages if any between different reopeners in place needs to be considered.

We trust this will be helpful and look forward to continuing our engagement on this matter. Should you have any questions on our response, please do not hesitate to contact me.

Yours sincerely

**Paul Auckland**  
**Head of Economic Regulation**