The RIIO2 price control: the opportunities and challenges ahead

SESSION 4 – REGULATION AND INNOVATION FOR SMARTER AND CLEANER ENERGY MARKETS & NETWORKS
Why there is a need to change RIIO framework?

The need for the RIIO2 framework change is driven by two overarching reasons.

### Framework Evolution –
To address observed and perceived issues with current RIIO-1 framework

- Application of the principles and objectives of the RIIO framework
- Risk allocation
- Skew of expected returns
- Forecasting errors & information asymmetry

### External drivers –
to ensure a framework capable of adapting to the wider range of plausible energy futures

- Government Policy
- Rapid reduction in the cost of distributed generation
- Advances in digital technology
- Change in the end consumer behaviour
Key Topic Ofgem is considering in evolving RIIO framework

**Stronger Consumer voice**
- New approach to stakeholder engagement with introduction Customer/User groups which will provide input and challenge business plans
- Introduction of RIIO2 Challenge group and Open hearings

**Simplifying the price controls**
- Removal of fast-tracking in transmission and retention in distribution
- Consideration of simpler approach to incentivise quality business plan submission
- Greater use of indexation in determining cost allowances, use of volume drivers, extension of SWW approach

**Fair returns and financeability**
- New methodology for cost of equity
- Move from RPI to CPI (CPIH)
- New options for debt indexation
- Introduction of five failsafe mechanisms against higher than expected returns

**Responding to how networks are used**
- Support of outcomes which benefit whole system
- Efficient utilisation of existing assets and greater justification of new investment
- Potential role for licensees in reducing future demand

**Driving innovation and efficiency**
- Innovation: increased involvement of 3rd parties, coordination with other public innovation funding
- Competition: extended across all sectors, development of late models and consideration potential for early solutions

**Outputs definition**
- Outputs to be defined at the sector specific strategies with NOMs retained
- Possibility of output delivery incentives for service quality improvements beyond the minimum standard

- Outputs definition
- How network is used
- Innovation & efficiency
- Consumer voice
- Simpler control
- Fair return
# Stronger Consumer voice - Opportunities & Challenges

## Introduction

### Customer/User groups

**Opportunities**
- Enable wider acceptance of final settlement and increased transparency of business plan evolution
- Ensure customer/consumer ownership of the final outcome
- Less planning/environmental/societal objections
- Change in the end consumer behaviour

**Challenges**
- Tight timescale to engage and educate range of different stakeholders
- Limited pool of suitable candidates to chair/participate in >20 stakeholder groups/panels
- Stakeholder fatigue
- Further clarity required on exact role of Challenge and open hearing group to avoid ambiguity and possibility to undermine previous engagement

## Key areas

**Introduction of RIIO2 Challenge group and Open hearings**

**Stronger consumer/customer voice and greater acceptance of business plan**

With >20 stakeholder groups/panels there is a risk of stakeholder fatigue.
### Key areas

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<tr>
<th>Length of the price control</th>
<th>Opportunities</th>
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<tbody>
<tr>
<td></td>
<td>• Enable closer alignment between assumptions, forecast and actual requirements.</td>
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<td>• Revenue detached from TO RAV</td>
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<td>• Ability to drive whole system thinking</td>
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<tr>
<th>Separate price control for SO</th>
<th>Opportunities</th>
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<td></td>
<td>• Potential in encouraging end-use energy efficiency, particularly in relation to heat decarbonisation point</td>
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<td>• Less resource constraint on both industry &amp; Ofgem</td>
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<td>• Enables lessons learned between earlier and later sectors</td>
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<th>Whole system outcomes</th>
<th>Opportunities</th>
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<td>• Shorter period reduces potential for forecasting errors and separate SO price control promote whole system thinking</td>
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<tr>
<th>No alignment between price controls</th>
<th>Challenges</th>
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<td></td>
<td>• Shorter period limits company ability to plan over a longer-term horizon and realise cost efficiencies associated with it</td>
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<td>• How to determine allowance for asset light SO</td>
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<td>• Relationships, roles and responsibilities between SO and DSO</td>
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<td></td>
<td>• Lack of drivers/incentives to align individual licences actions with whole system requirements</td>
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<td>• Staggered price controls limits more holistic approach to managing whole system outcomes</td>
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<td>• It can undermine incentives for licensees to develop whole system solutions potentially increasing the overall cost of the energy system</td>
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<td>• Limits coordination of planning processes between licences</td>
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| Lack of drivers/incentives to align individual licenses actions with whole system requirements |
Driving innovation and efficiency—Opportunities & Challenges

Key areas

- **Dedicated innovation funding**
- **Coordination of innovation with wider public funding**
- **Extending competition across all sectors**

Opportunities

- Faster development of transformational innovative technologies (longer payback horizon)
- More efficient innovation with greater access for 3rd parties
- Efficient use of innovation funding (prevents overlaps)
- Potential to enable more efficient delivery of the investment
- Faster adoption of transformative innovation.
- Potential for more efficient asset delivery

Challenges

- How to differentiate between incremental and transformational innovation
- How to accommodate interdependencies between different funding mechanisms (e.g. Network innovation funding benefiting 3rd parties and not network/consumers directly)
- Suitability of transmission defined criteria onto distribution assets
- Balancing need for efficient delivery against complexity of having multiple operators in the same area
- Difficulty in differentiating incremental and transformative innovation.
- Suitability of transmission defined criteria onto distribution assets
## Simpler Control - Opportunities & Challenges

### Key areas

<table>
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<th>Challenges</th>
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<tr>
<td>• Removal of fast-tracking in Tx and (r)evolution of IQI</td>
<td>• Difficulty to gauge suitability of options in absence of upfront clarity on actual details</td>
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<td>• Approach for setting outputs and incentives</td>
<td>• Lack of detail on different benchmarking approaches (sector specific document)</td>
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<td>• Annual review of actual licensee costs</td>
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<td>• Improved annual reporting</td>
<td>• Individual companies record data in different formats</td>
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<td>• Difficult to link actual expenditure and outputs consistently</td>
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- **Opportunities**
  - Introduction of simpler, clearer and more efficient upfront business plan incentive
  - Use of consumer-facing outcomes similar to the RIIO 1
  - Greater use of volume drivers and uncertainty mechanisms will enable flexible framework
  - More accurate and simpler tracking of how companies and regulatory framework performs
- **Challenges**
  - Lack of details on upfront incentive
  - How to link accurately actual expenditure vs. outputs
**Fair Returns - Opportunities & Challenges**

**Key areas**

**Cost of Debt**
- Simpler, more transparent debt indexation methodology (3 options on table)
- Improved Cost of equity methodology (UKRN study recommendation)
- Introducing indexation of CoE to remove subjectivity
- Introduce greater protection against “higher returns” while retaining an incentive-based framework

**Cost of equity**
- Complexity for some of the debt indexing options and possibility to pick arbitrary winners or losers
- Increased complexity
- Calculation of individual CoE parameters (TMR, beta, risk free rate)
- Appropriateness of direct translation of current market evidence into the CoE methodology
- Number of proposed mechanisms score poorly against principles of good regulation
- It can decouple actual performance from achieved return

**Failsafe Mechanisms**
- Increased complexity of new CoC methodology
- Decoupling performance from achieved return

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**Failsafe Mechanisms**
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Final remarks

• RIIO-2 will be stakeholder-led, allowing co-creation of business plans but right balance needs to be struck to prevent stakeholder fatigue

• The external environment is ‘tough’, requiring network companies to make a clearer link between performance and returns.

• Ideally, RIIO2 as an output based framework needs to be focused on rewarding and penalising outputs and outcomes and resist temptation (as much as possible) to transition into input-based regulation

• Continuing support for transformational innovation with greater access to 3rd party funding but focus is required to promote joint-up whole system approach, this is where some of the biggest challenges and knowledge gaps sit.