The RIIO2 price control: the opportunities and challenges ahead

SESSION 4 – REGULATION AND INNOVATION FOR SMARTER AND CLEANER ENERGY MARKETS & NETWORKS

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Presented To: EPRG Spring Seminar

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

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

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

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

Stronger Consumer voice-Opportunities & Challenges

Key areas	Opportunities	Challenges
Introduction Customer/User groups	• Enable wider acceptance of final settlement and increased transparency of business plan evolution	• Tight timescale to engage and educate range of different stakeholders
	• Ensure customer/consumer ownership of the final outcome	• Limited pool of suitable candidates to chair/participate in >20 stakeholder groups/panels
Introduction of RIIO2 Challenge group and Open hearings	• Less planning/environmental/societal objections	• Stakeholder fatigue
	• Change in the end consumer behaviour	• Further clarity required on exact role of Challenge and open hearing group to avoid ambiguity and possibility to undermine previous engagement

Stronger consumer/customer voice and greater acceptance of business plan

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

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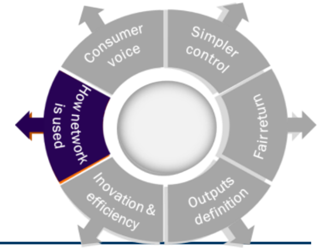
Responding to how networks are used – Opportunities & Challenges



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

Shorter period reduces potential for forecasting errors and separate SO price control promote whole system thinking

Lack of drivers/incentives to align individual licenses actions with whole system requirements

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Driving innovation and efficiency–Opportunities & Challenges

Key areas	Opportunities	Challenges
Dedicated innovation funding	• Faster development of transformational innovative technologies (longer payback horizon)	• How to differentiate between incremental and transformational innovation
Coordination of innovation with wider public funding	• More efficient innovation with greater access for 3rd parties • Efficient use of innovation funding (prevents overlaps)	• How to accommodate interdependencies between different funding mechanisms (e.g. Network innovation funding benefiting 3rd parties and not network/consumers directly)
Extending competition across all sectors	• Potential to enable more efficient delivery of the investment	• Suitability of transmission defined criteria onto distribution assets • Balancing need for efficient delivery against complexity of having multiple operators in the same area

- **Faster adoption of transformative innovation.**
- **Potential for more efficient asset delivery**

- **Difficulty in differentiating incremental and transformative innovation.**
- **Suitability of transmission defined criteria onto distribution assets**

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Simpler Control -Opportunities & Challenges

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

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Fair Returns-Opportunities & Challenges

Key areas	Opportunities	Challenges
Cost of Debt	• Simpler, more transparent debt indexation methodology (3 options on table)	• Complexity for some of the debt indexing options and possibility to pick arbitrary winners or losers • Increased complexity
Cost of equity	• Improved Cost of equity methodology (UKRN study recommendation) • Introducing indexation of CoE to remove subjectivity	• Calculation of individual CoE parameters(TMR, beta, risk free rate) • Appropriateness of direct translation of current market evidence into the CoE methodology
Failsafe Mechanisms	• Introduce greater protection against "higher returns" while retaining an incentive-based framework	• Number of proposed mechanisms score poorly against principles of good regulation • It can decouple actual performance from achieved return

Opportunities:
- **Simpler, more transparent CoC methodology**
- **Increased protection against "higher returns"**

Challenges:
- **Increased complexity of new CoC methodology**
- **Decoupling performance from achieved return**

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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.