

# The RII02 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



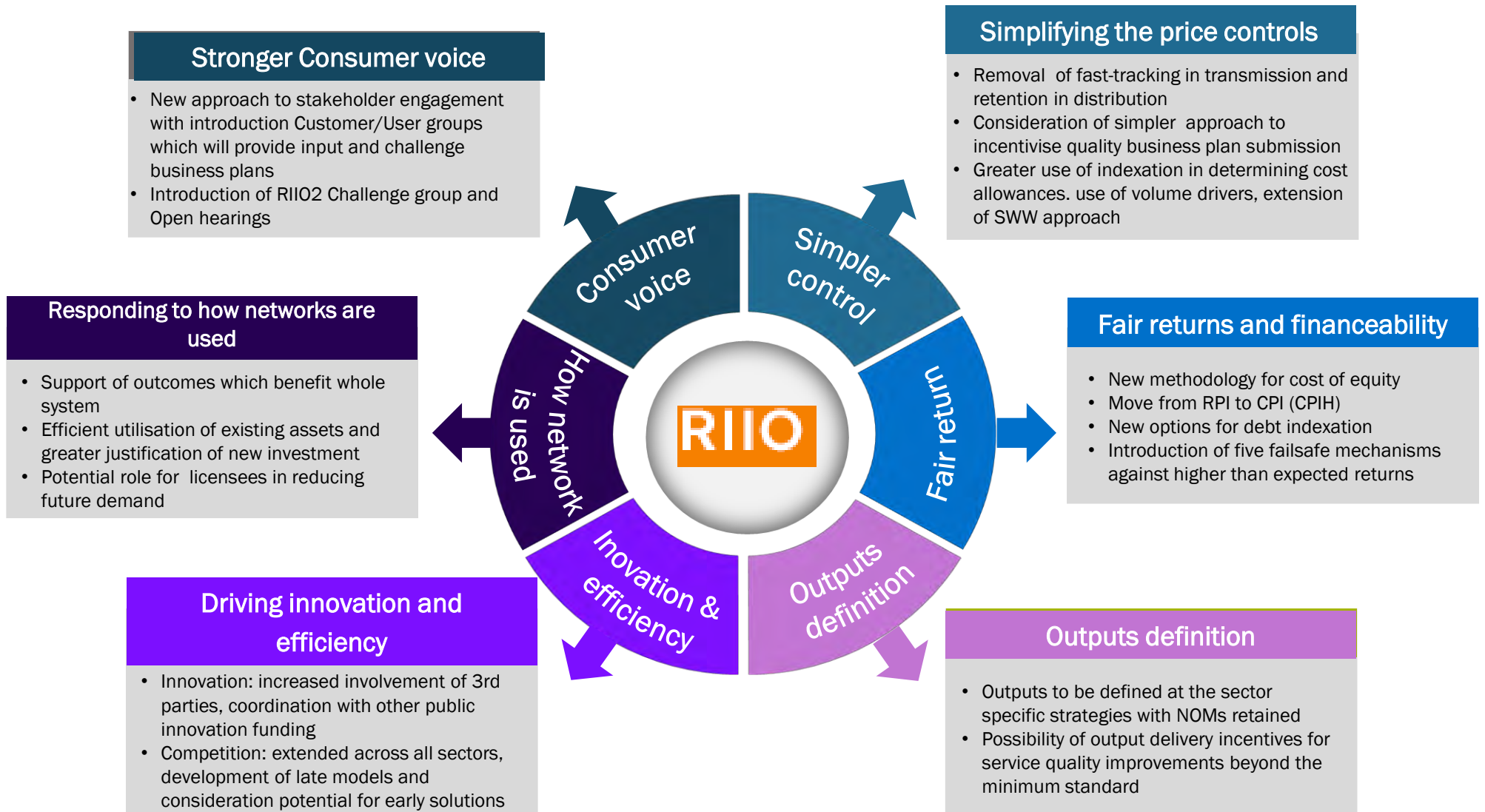
Advances in digital technology



Change in the end consumer behaviour



# Key Topic Ofgem is considering in evolving RIIO framework

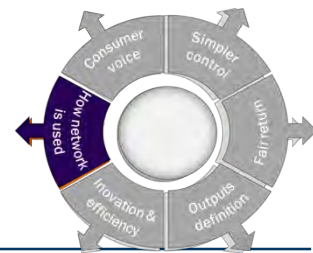


# Stronger Consumer voice-Opportunities & Challenges



Key areas	Opportunities	Challenges
Introduction Customer/User groups	<ul style="list-style-type: none"> <li>• Enable wider acceptance of final settlement and increased transparency of business plan evolution</li> <li>• Ensure customer/consumer ownership of the final outcome</li> </ul>	<ul style="list-style-type: none"> <li>• Tight timescale to engage and educate range of different stakeholders</li> <li>• Limited pool of suitable candidates to chair/participate in &gt;20 stakeholder groups/panels</li> </ul>
Introduction of RIIO2 Challenge group and Open hearings	<ul style="list-style-type: none"> <li>• Less planning/environmental/societal objections</li> <li>• Change in the end consumer behaviour</li> </ul>	<ul style="list-style-type: none"> <li>• Stakeholder fatigue</li> <li>• Further clarity required on exact role of Challenge and open hearing group to avoid ambiguity and possibility to undermine previous engagement</li> </ul>
	<p><b>Stronger consumer/customer voice and greater acceptance of business plan</b></p>	<p><b>With &gt;20 stakeholder groups/panels there is a risk of stakeholder fatigue.</b></p>

# Responding to how networks are used – Opportunities & Challenges



## Key areas

Length of the price control

Separate price control for SO

Whole system outcomes

No alignment between price controls

## Opportunities

- Enable closer alignment between assumptions, forecast and actual requirements.
- Revenue detached from TO RAV
- Ability to drive whole system thinking
- Potential in encouraging end-use energy efficiency, particularly in relation to heat decarbonisation point
- Less resource constraint on both industry & Ofgem
- Enables lessons learned between earlier and later sectors

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

## Challenges

- Shorter period limits company ability to plan over a longer-term horizon and realise cost efficiencies associated with it
- How to determine allowance for asset light SO
- Relationships, roles and responsibilities between SO and DSO
- 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
- 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

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

# Driving innovation and efficiency—Opportunities & Challenges



Key areas	Opportunities	Challenges
Dedicated innovation funding	<ul style="list-style-type: none"> <li>Faster development of transformational innovative technologies (longer payback horizon)</li> </ul>	<ul style="list-style-type: none"> <li>How to differentiate between incremental and transformational innovation</li> </ul>
Coordination of innovation with wider public funding	<ul style="list-style-type: none"> <li>More efficient innovation with greater access for 3<sup>rd</sup> parties</li> <li>Efficient use of innovation funding (prevents overlaps)</li> </ul>	<ul style="list-style-type: none"> <li>How to accommodate interdependencies between different funding mechanisms (e.g. Network innovation funding benefiting 3<sup>rd</sup> parties and not network/consumers directly)</li> </ul>
Extending competition across all sectors	<ul style="list-style-type: none"> <li>Potential to enable more efficient delivery of the investment</li> </ul>	<ul style="list-style-type: none"> <li>Suitability of transmission defined criteria onto distribution assets</li> <li>Balancing need for efficient delivery against complexity of having multiple operators in the same area</li> </ul>
	<ul style="list-style-type: none"> <li><b>Faster adoption of transformative innovation.</b></li> <li><b>Potential for more efficient asset delivery</b></li> </ul>	<ul style="list-style-type: none"> <li><b>Difficulty in differentiating incremental and transformative innovation.</b></li> <li><b>Suitability of transmission defined criteria onto distribution assets</b></li> </ul>

# Simpler Control - Opportunities & Challenges



## Key areas

Removal of fast-tracking in Tx and (r)evolution of IQI

Approach for setting outputs and incentives

Improved annual reporting

## 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

- Introduction of simpler, clearer and more efficient upfront business plan incentive.
- Consistent and comparable reporting

## Challenges

- Difficulty to gauge suitability of options in absence of upfront clarity on actual details
- Lack of detail on different benchmarking approaches (sector specific document)
- Annual review of actual licensee costs
- Individual companies record data in different formats
- Difficult to link actual expenditure and outputs consistently

- Lack of details on upfront incentive
- How to link accurately actual expenditure vs. outputs

# Fair Returns-Opportunities & Challenges



## Key areas

### Cost of Debt

### Cost of equity

### Failsafe Mechanisms

## Opportunities

- Simpler, more transparent debt indexing 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

- **Simpler, more transparent CoC methodology**
- **Increased protection against “higher returns”**

## Challenges

- 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

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



- 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 3<sup>rd</sup> 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.