

RIIO-ED2 framework decision

8 January 2020

Ofgem has published its decision on the framework for the second round of RIIO price controls for the GB electricity distribution networks (RIIO-ED2).¹

Overall, Ofgem has aligned many of the decisions for the electricity distribution networks with the RIIO-2 methodologies for electricity transmission and gas networks. However, a number of strategic issues and specific decisions remain open for discussion (e.g. as part of the RIIO-ED2 working groups) and will form a key part of the RIIO-ED2 sector-specific methodology consultation process, which is due to run in Q2–Q3 2020.

This note summarises key aspects of the RIIO-ED2 framework decision and strategic issues facing the sector that Ofgem is considering.

1 RIIO-ED2 framework decision: summary

Length of the price control

- Five-year price control period, in line with the other sectors.

Enabling whole system solutions

- Ofgem confirmed that the start or finish dates of the electricity distribution and transmission price controls would not be aligned. It proposed that where more targeted support of whole system outcomes is needed, it will develop additional tools in line with other sectors, such as through calibration of the Coordinating Adjustment Mechanism (CAM).

Giving consumers a stronger voice

- Application of the same enhanced engagement arrangements for RIIO-ED2 that were introduced for the gas distribution and gas and electricity transmission network RIIO-2 price controls—i.e. distribution network operators (DNOs) would be required to set up a Customer Engagement Group (CEG); Ofgem will set up a central RIIO-2 Challenge Group (CG); and Ofgem to hold open, public hearings ahead of the final determinations.

Overarching framework for outputs and incentives

¹ Ofgem (2019), 'RIIO-ED2 Framework Decision', 17 December.

Oxera Consulting LLP is a limited liability partnership registered in England no. OC392464, registered office: Park Central, 40/41 Park End Street, Oxford OX1 1JD, UK; in Belgium, no. 0651 990 151, branch office: Avenue Louise 81, 1050 Brussels, Belgium; and in Italy, REA no. RM - 1530473, branch office: Via delle Quattro Fontane 15, 00184 Rome, Italy. Oxera Consulting (France) LLP, a French branch, registered office: 60 Avenue Charles de Gaulle, CS 60016, 92573 Neuilly-sur-Seine, France and registered in Nanterre, RCS no. 844 900 407 00025. Oxera Consulting (Netherlands) LLP, a Dutch branch, registered office: Strawinskylaan 3051, 1077 ZX Amsterdam, The Netherlands and registered in Amsterdam, KvK no. 72446218. Oxera Consulting GmbH is registered in Germany, no. HRB 148781 B (Local Court of Charlottenburg), registered office: Rahel-Hirsch-Straße 10, Berlin 10557, Germany.

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- Use of the same overarching RIIO-2 framework for outputs and incentives for the electricity distribution companies—namely, three overarching output categories: (i) meet the needs of consumers and network users; (ii) maintain a safe and resilient network; and (iii) deliver an environmentally sustainable network. Relative and dynamic incentive targets could be applied to the outputs where they will drive value for consumers.²

Maintaining a safe and resilient network

- Ofgem will apply the Network Asset Risk Metric (NARM) for RIIO-ED2, as part of a toolbox approach to justifying and assessing network companies' (proposed) investments and preferences for their chosen strategies in maintaining a safe and resilient network.³

Delivering an environmentally sustainable network

- Transition to a low-carbon energy system is a key theme for the RIIO-2 price controls. Ofgem's expectation is that DNOs should focus on decarbonising their own networks, reducing the environmental impact of network activity, and supporting the transition to a smarter, more flexible and sustainable low-carbon energy system. However, Ofgem did not prescribe how this should be achieved, but signalled that it would consider how DNOs' activities could be funded, the outputs and incentives they should be exposed to, as well as how their performance should ultimately be measured as part of the relevant RIIO-ED2 working groups.

Managing uncertainty

- Ofgem confirmed that it will: (i) use indexation where feasible; (ii) invite networks to propose highly anticipatory projects in their business plans; and (iii) offer DNOs the opportunity to set out in their business plan how these highly anticipatory investments should be treated.

Driving efficiency through innovation and competition

- Ofgem will: (i) remove the Innovation Rollout Mechanism (IRM) re-opener; (ii) introduce a new innovation funding pot that targets future-facing strategic challenges; and (iii) retain the opportunity for network companies to receive Network Innovation Allowance (NIA) funding.
- Ofgem will continue to work towards introducing early and late competition models.

Business plan and TOTEX incentives

- Ofgem proposed to: (i) remove the early settlement process for RIIO-ED2; (ii) set incentive rates via a confidence-dependent incentive rate approach; and (iii) use the Business Plan Incentive (BPI) that would reward high-quality and ambitious business plans.

Fair returns and financeability

- On the finance issues, Ofgem proposed to: (i) retain debt indexation for RIIO-2; (ii) set the baseline allowed return on equity using the same

² Dynamic-relative incentives targets refer to targets that would evolve during the price control period to take account of improvements in performance across the sector. These targets would allocate rewards or penalties on a relative assessment of performance.

³ NARM is defined as the relative reduction of long-term monetised network asset risk.

methodology as the other sectors; and (iii) use either CPI or CPIH for inflation measurement in calculating both RAV and allowed returns.

Return adjustment mechanisms

- Ofgem will introduce the sculpted sharing factor Return Adjustment Mechanism (RAM) for RIIO-ED2.

2 RIIO-ED2 framework decision: key strategic issues

In addition to the framework decisions summarised above, Ofgem set out a number of strategic issues that would inform the development of the RIIO-ED2 sector methodology. It will explore how to tackle these issues through five RIIO-ED2 working groups that cover: (i) overarching approach to setting RIIO-ED2; (ii) safety, resilience and reliability; (iii) customer service, vulnerability and connections; (iv) decarbonisation and the environment; and (v) cost assessment.

The strategic issues to be covered by the working groups include the following.

- **How to support decarbonisation goals?** In light of Ofgem's Strategic Narrative⁴ and government net zero targets, Ofgem will set out initial actions to drive decarbonisation in the energy sector early in 2020, and this will also inform the work on RIIO-ED2.
- **How to set price controls that support strategic investment?** In the context of achieving net zero targets, Ofgem considers that the role of anticipatory investment may acquire more prominence in RIIO-2. The arrangements for supporting investment will form part of the working group agenda.
- **How to set price controls for DSO functions?** Ofgem signalled that it may decide to separate certain system operator functions from the DNOs. As a result, it may include a reopener within RIIO-ED2 that would allow for adjustments to the price control to reflect DSO separation arrangements, should it decide that separation is required.
- **How to set price controls that drive innovation and competition?** Ofgem considers that companies should innovate more to deliver short-term financial efficiencies within BAU activities, while the innovation stimulus should focus more on the energy system transition, increasingly coordinate with other public funders, and increase third-party involvement. Ofgem outlined some of the measures aimed at innovation and competition as part of the RIIO-ED2 decisions (e.g. a new innovation funding pot for future-facing strategic challenges and retained NIA funding). It highlighted that additional tools for driving innovation and competition may be developed during the RIIO-ED2 sector-specific methodology.
- **How to set price controls for a smart, flexible energy system?** Ofgem highlighted the important role of 'flexibility' markets and services that may increasingly offer lower-cost routes to delivering an output. It stressed the importance of DNOs in enabling these markets to develop, and expects the

⁴ Ofgem (2019), 'Ofgem strategic narrative: 2019-23', 11 July, <https://www.ofgem.gov.uk/publications-and-updates/ofgem-strategic-narrative-2019-23>.

Open Networks Project to support development and coordination of flexibility markets.⁵

- **How to set price controls in a big data environment?** Ofgem identified that the modern data environment and data access could enable a range of parties to take on new roles in delivering a fully decarbonised system. It will provide further guidance on how this area might affect the RIIO-ED2 methodology following the conclusion of its ongoing data best practice workstream and forthcoming consultation on a Whole Electricity Systems licence change.

3 Oxera commentary

While the RIIO-ED2 framework decision is largely aligned with the other RIIO-2 methodologies, Ofgem has left open decisions on the specific implementation of a number of regulatory mechanisms to the sector-specific methodology stage for DNOs. In addition, there are some strategic issues that are specific to the electricity distribution networks (e.g. how to deal with decentralisation of electricity flows at a distribution level) that may require a bespoke approach in RIIO-ED2. For example, there remain questions (among other factors) in relation to the following areas.

- The coverage and design of uncertainty mechanisms, including the definition of relevant indices for cost allowances.
- The framework decision confirmed that the outputs will be specified as a set of consumer-facing outcomes, which can be distinguished as licence obligations (LOs), price control deliverables (PCDs), and output delivery incentives (ODIs). The calibration of incentives will play a major part in the sector-specific methodology engagement. In the case of relative and dynamic incentive targets, a particular consideration should be given to the effect of such targets on collaboration within the industry.
- The calibration of the sculpted sharing factor RAM has not been fully specified, so further regulatory focus is likely in defining an appropriate cap and collar on Return on Regulatory Equity (RoRE) and calibrating the sharing factors relative to these thresholds.
- Ofgem decided to replace the Information Quality Incentive (IQI) in RIIO-2 with a TOTEX incentive rate that reflects its level of confidence in its ability to independently set cost allowances. Under the scheme, Ofgem will independently assess a proportion of overall TOTEX where it has 'high-confidence' in its ability to independently set the cost allowances. The proportion of 'high-confidence' TOTEX would be associated with a higher incentive rate that would allow the companies to retain a greater proportion of cost outperformance. Further regulatory focus will be needed on the classification of DNO costs within different cost-confidence categories.
- In addition to the revised TOTEX incentive mechanism, Ofgem will use a BPI to reward high-quality and ambitious business plans. Therefore, networks will need to engage with Ofgem on what level of risk and return they are willing to bear in the next control, with the potential to propose bespoke outputs, ambition in business plans and highly anticipatory

⁵ Open Networks Project: is the programme of work being led by the Energy Networks Association to deliver the policies set out in the Ofgem and BEIS Smart Systems and Flexibility Plan, the government's Industrial Strategy and the Clean Growth Plan. See Ofgem (2019), 'RIIO-ED2 Framework Decision', 17 December, p. 13.

investments. In this context, it will be important to present a high degree of evidence of expected consumer benefit from new investment programmes to support a well-justified business plan.

- Ofgem signalled that the system operator function could be separated from the DNOs in the future. To the extent that DNOs are incentivised and remunerated to transition from network operation to system operation and services provision, the facilitation of this pathway in the regulated price controls is yet to be designed.
- As with the other RIO-2 methodologies, the RIO-ED2 preparation envisages significant stakeholder engagement and public scrutiny of networks' business plans in the run-up to the final determinations.

4 Next steps

In Q2–Q3 2020, Ofgem will consult on the sector-specific methodologies, and this should provide companies with a clearer steer on the final framework design. The final methodologies are due in Q4 2020.
