

# Consultation Response

## **EUA response to the Ofgem open letter on the RIIO-2**

### **Framework**

Energy and Utilities Alliance welcome the opportunity to comment on the new price control RIIO-2

The Energy and Utilities Alliance (EUA) is a not for profit trade association that provides a leading industry voice to help shape the future policy direction within the energy and utilities sector. Our association comprises 6 divisions: Utility Networks (UN), the Heating and Hotwater Industry Council (HHIC), the Industrial & Commercial Energy Association (ICOM), the Hot Water Association (HWA), the Manufacturers' Association of Radiators and Convector (MARC) and the Natural Gas Vehicles Network (NGV Network).

As part of our Utility Networks division, we represent the gas distribution supply chain.

We understand the need to meet the energy trilemma and support the role that RIIO-2 and GD1 play in achieving this. It is vital that energy costs are affordable and that transmission and distribution are efficient and cost effective. We also strongly support the role RIIO has played in reducing fuel poverty and in spearheading innovation.

EUA response:

#### **1 - Do you agree with our overarching objective for RIIO-2 and how we propose to achieve it?**

EUA and our member companies broadly agree with the overarching objective for RIIO-2. The focus should be on ensuring a well operated and fair market for customers, stakeholders and networks.

RIIO-1 has provided a framework to deliver this and we hope that RIIO-2 looks to improve on this rather than make radical changes.

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We believe that the affordability of the networks and consumer satisfaction levels are testament that this is a well-run market that is operating in the national interest.

We also believe that the annual reports in relation to the Gas Distribution Networks (GDNs) demonstrate that they are working well. There are obviously improvements that should be made and we accept that there must not be any complacency in ensuring we aim for higher standards and even higher levels on customer satisfaction.

For this to be achieved we believe that RIIO-2 needs to focus on working with the industry to make manageable changes rather than wholesale change. Any shocks to the system could lead to the progress we are making being reversed.

Whilst we agree with the overarching aims of RIIO-2, our members believe that it should be recognised that there are a broad range of stakeholders not just consumers, who all have a stake in this operating in an efficient and fair manner. Therefore the voice of stakeholders should be considered in a similar manner to those of customers. It should also be noted that RIIO-1 has led to increased consumer participation.

Finally we believe that RIIO-2 needs to strike a balance between ensuring costs are low today but also that costs are low in the future. This should allow for spending on innovation and schemes to ensure a future gas grid is modern safe and ready to serve the UK for another hundred years.

### **4 - Does this structured approach to defining outputs provide the right level of clarity around delivery?**

On one level this approach does provide some degree of clarity. It provides a platform to determine outputs for delivery and allows stakeholders and consumers the possibility of assessing current and future delivery outcomes.

However there are issues regarding clarification on what the output areas actually encompass and how they relate to secondary outputs. In particular this relates to how stakeholders and consumers assess these outputs.

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EUA members have also questioned whether the outputs are SMART enough? Ofgem should be getting inputs from all areas on what's working what's not and if further clarification is needed.

EUA members have also asked how relatable these outputs are to customers. For example how would a customer describe the purpose of an output?

On balance however, the described outputs are an improvement from previous price controls and they do provide some level of clarity.

EUA believes that this is an evolutionary process. The stated outputs provide a good base for defining delivery and we would not want RIIO-2 to discard this process.

There are however some disconnects and areas that cannot be easily attributed to one primary output

### **5 - How can the outputs framework be improved, including the introduction of additional output categories for example around efficient system operation for distribution network companies?**

EUA members believe that consideration for longer term return on investment should be considered in the output categories. This would help encourage innovation for more efficient system operation.

### **6 - Did the outputs target the right behaviours?**

EUA believes that the outputs did target the right behaviours. The RIIO-1 programme made significant steps in the right direction. The table below shows how over the first three years of RIIO-1 the GDNs have continually improved on their overall customer satisfaction score.

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Customer satisfaction with network owners: Gas distribution (RIIO-GD1)



[Chart Link](#)

Source: RIIO gas distribution annual report 2015-16. Information correct as of: February 2017

However there is agreement that steps are needed to make sure there are better linkages between secondary and primary outputs. It can be difficult to differentiate between the two. Better delineation would improve delivery on these outputs to consumers.

One area identified whereby the outputs failed to assist was where there were no outputs for certain developments such as peaking, biomethane, green gas etc. These areas are critical for the long term future for low carbon UK energy and therefore should correlate to an output to encourage their development.

## 7 - How can we address areas of expenditure for which a clear output is difficult to define?

EUA believes that we would need to understand the gap in the outputs to a greater degree and then balance this accordingly.

Expenditure in published reports is not linked to the output areas. Linking the two would be a sensible move to clarify gaps. With this information we can then determine the most appropriate action; either to expand an output or clarify where difficult to define expenditure should be apportioned.

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### **18 - What amendments to the RIIO framework, if any, should we consider in supporting companies to make full use of smart alternatives to traditional network investment?**

Currently the RIIO framework does not encourage an advanced level of integration between the electricity and gas distribution networks.

Currently the gas distribution network provides a high level of energy storage that is vital to the balancing of the electricity network

Therefore we need more of a system approach and appropriate incentives on both.

EUA believes that some level of integration of the frameworks could avoid expensive electricity storage investment decisions where the gas network would offer a more cost effective solution. It would also help recognise that the gas distribution network does not just distribute gas to be combusted in homes and industrial processes, but it also has a large network of small electricity generating sites to support peak electricity demand.

EUA also would like Ofgem to consider the role of the retailer and how to join them into the process to improve services delivered to consumers.

### **19 - Given the uncertainty around demand for network services, how much of an issue might asset stranding be and how should this risk be dealt with?**

For the gas distribution networks, EUA does not believe there is a credible decarbonisation pathway that does not include significant need for a fully functional and modern gas network. Therefore there should not be any presumed uncertainty over its future.

However the industry does not believe that BEIS and Ofgem have articulated this in recent strategy documents. This is despite:

- Too Hot to Handle

<https://policyexchange.org.uk/publication/too-hot-to-handle/>

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- Future Heat Series Part 2 - Policy for Heat  
<http://www.policyconnect.org.uk/cc/research/report-future-heat-series-part-2-policy-heat>
- 2050 Energy Scenarios  
<http://www.energynetworks.org/assets/files/gas/futures/KPMG%20Future%20of%20Gas%20Main%20report%20plus%20appendices%20FINAL.pdf>
- The future of heating in UK buildings  
<https://www.theccc.org.uk/2016/10/13/infographic-the-future-of-heating-in-uk-buildings/>
- Future Energy Scenarios  
<http://fes.nationalgrid.com/media/1253/final-fes-2017-updated-interactive-pdf-44-amended.pdf>

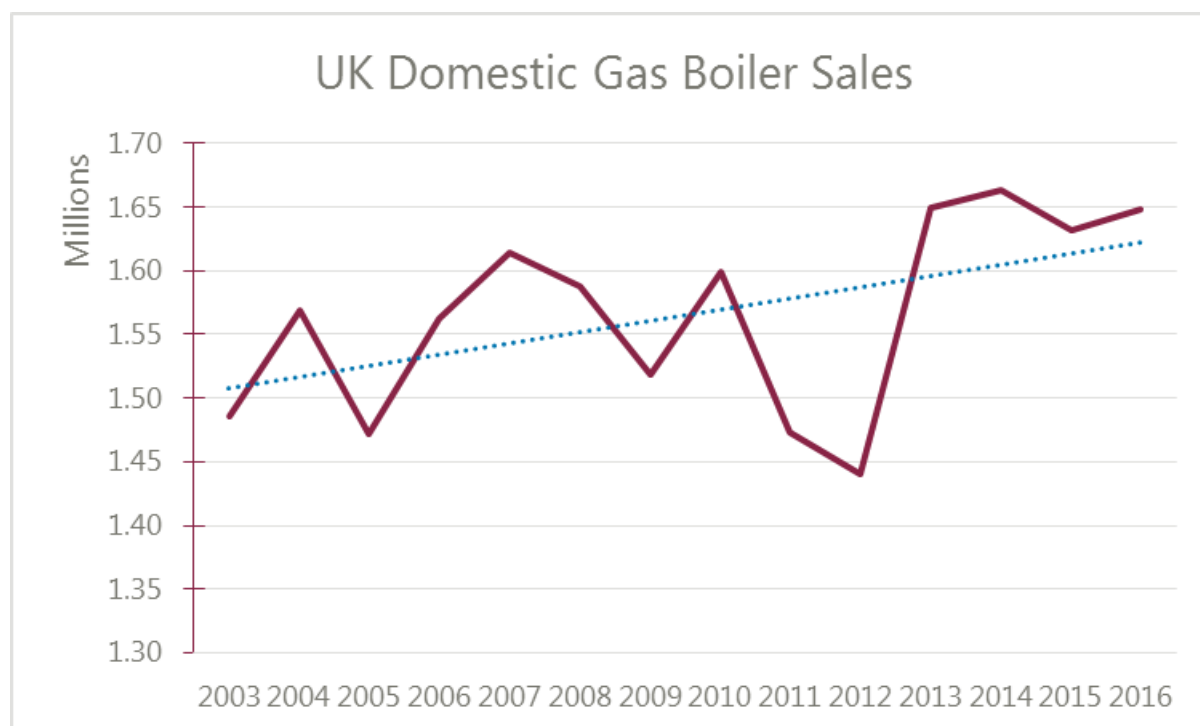
The gas pipe network will also be a key function of future non-methane pathways. Therefore even if the network is reutilised in a manner that is not currently its principal use, the need for a safe and modern gas pipe network will be critical.

For this reasons unlike with disruptive electricity systems, the gas system does not have the same uncertainty for its asset and stranding is not a credible risk.

RIIO-1 allowed for the continued iron mains replacement programme, this is due to be completed in 2032. This is being delivered in an orderly and cost effective manner, unlike some other mandated energy system upgrades. This is being costed on the basis of a long term depreciation of the gas network as an asset. This also keeps costs to consumers low. The impact of changing the risk profile to require a return on investment on a shorter depreciation term would increase running costs and ultimately would be passed on to consumers in the form of higher costs. EUA therefore urges Ofgem to ensure that depreciation can be kept as a long term calculation.

Through EUA's domestic heating trade association we know that the sale of gas boilers has increased since the start of the first price control period.

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At the time it was widely believed that gas heating may be phased out and that by the end of the 2010's gas boiler sales would be significantly lower. However as illustrated this is not the case. Other heating products have not gained traction and the RHI for domestic heating has been a widely regarded failure. Therefore there is far less uncertainty now over the future of gas heating. The complexity is that gas heating remains a cheap and reliable option, increasingly difficult to replicate or replace.

The Gas Distribution Networks have informed us that business models at the moment show significant investment into the gas network, demonstrating confidence in its future.

### **20 - How do we need to adapt the RIIO framework, and the uncertainty mechanisms in particular, to deal with this uncertainty?**

There is a general need for the UK government to clarify its position with regards to overall energy policy, especially with the possibility of the UK's exit from the EU and therefore from its regulations on future energy reduction.

The carbon reduction plan is due to be released in the autumn, but we are not expecting this document to clarify the situation.

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However this gap in the policy framework has led to the market starting to define likely low carbon trajectories, and a gas future with decarbonised gas looks feasible and likely.

Therefore there is no central need to change RIIO in line with this situation.

The one comment our members have passed on to us is that the 8 year RIIO settlement is deemed suitable for planning and innovation and should be retained. It also provides stability for the supply chain as they know how many years they can plan product and service delivery for. For example if the product may take 2-3 years to develop, an 8 year programme enables this to still be a viable investment.

### **21 - Is an eight-year price control period with built-in uncertainty mechanisms still appropriate given the greater range of plausible future scenarios?**

EUA believes that an eight year price control provides suitable insulation from policy volatility and therefore allows for planning, innovation and suitable depreciation mechanisms.

There is a risk that if too many new indices and uncertainty mechanisms are built in then this could undermine the 8 year overall price control. We therefore urge Ofgem not to add too many possible break or review points that in effect create a number of mini controls within the eight year control period.

Our members are particularly wary of the example in the water industry where the situation has been described to us as 'Feast and famine'. Companies need suitable time to build up systems, develop products and services and adapt to new settlements. Reducing the control period creates too much uncertainty and risk provide lower standard product to consumers.

There is also a concern that annual reviews can take away stability so the use of these should be managed. It was recognised that different sectors within RIIO do have differing requirements. So the eight year control period works well for the gas distribution industry, however a different approach may be more appropriate for transmission and electricity distribution. Therefore Ofgem should be able to customise the settlement for each sector depending on specific requirements.



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EUA would also like to remind Ofgem that before RIIO-1 the Ofgem consultants pushed for a ten year review period, ironically at the time the gas distribution businesses were sceptical that such a long review period would work. However RIIO-1 has demonstrated that the consultants were correct and that a longer period has more benefits for planning, efficiency and innovation.

### **22 - What improvements should be made to the assessment of business plans?**

The experience from RIIO-1 means that the new business plan will be better focused and should become a more useful document.

However EUA believes that Ofgem need to better use the business plans, potentially with better templates from Ofgem. Some EUA members believe that the documents are produced but not actually scrutinised which diminishes their purpose.

We recognise that for RIIO-1 they were all done in different ways which meant that Ofgem struggled to analyse them effectively, this could have led to them not being used in a productive manner. It is also harder to communicate outputs to consumer if not standardised.

It would be helpful for the industry if Ofgem could decide on the overall framework to help standardise the reports.

### **25 - What has an eight-year price control period allowed network companies to accomplish or plan for that would not have occurred under a shorter price control period?**

The principal benefit of an eight year control period has been on innovation, it allows for longer innovations to come into play. A shorter control period leads to shorter return innovations and pushes longer term innovation into academia. Too often innovation developed in academia fails to find its way into commercial development because it hasn't been allowed to be proven under commercial situations.

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An eight year price controls period has also allowed a better focus on stakeholders and customers along with creating stability in the supply chain.

The eight year programme has clear outputs so industry and the wider supply chain will develop a strategy to plan for that. It is argued that the focus on the iron mains replacement scheme, fuel poverty initiatives and innovative pipe excavation work has been possible because the eight year period has removed uncertainty and eliminated the phenomena of 'feast and famine'.

### **28 - What impact has the innovation stimulus had on driving innovation and changing the innovation culture?**

Overall EUA members believe that it has had a positive effect on stability and the necessary returns to make the innovation viable for both supplier and Network Company. In turn this has benefitted the consumer with better services and product.

We believe that the innovation stimulus has had a positive impact on the supply chain in terms of de-risked R&D, building of skills and competencies and value to the GB economy. The GDN's annual reports all clearly define the work that the stimulus has facilitated.

A number of member companies that operate within the supply chain, developing ancillary products and services for the gas distribution networks and other utility companies have informed us that one of the biggest issues has been getting to business as usual. There is good collaboration to develop the product or service, but the supply chain want to get to business as usual. This does not always happen and once the product has been built there is no guarantee that it will be utilised after the trial. However, we recognise that it is very hard to predict from the outset what innovation will ultimately be a success and the purpose of the stimulus is also to allow for certain risks to take place as long as overall there are positive outcomes. On balance both suppliers and Networks would rather the current system is maintained and possibly tweaked to improve certain delivery aspects rather than wholesale change, this is because GDN's are investing significantly in the implementation of innovation and the continuation of this into RIIO-2 will only lead to more positive outcomes.

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In order to facilitate interaction from the GDN's with the widest possible supply chain EUA in partnership with Cadent (National Grid at the time), in 2015, organised an 'Innovation Day' to allow companies in the supply chain to showcase their products and services directly to a GDN. This was a productive way to facilitate engagement between both parties. Other GDN's have operated similar schemes across the country, SGN organised a number of events around their Oban project. In October 2016 they held an event in London attended by over 90 delegates including Ofgem, BEIS, suppliers, politicians, academics, consultants and representatives of other interested parties across Europe to share their learnings from the Oban project and have engaged heavily with appliance manufacturers and EUA members.

One difficult issue is the Intellectual Property rights going public as this can be a barrier to innovation. The supply chain would like this situation reviewed. Businesses can make significant investment in innovating for a new product but then have no rights to sell this to other markets whilst maintaining IP rights. EUA understands the complexities of this, the public is effectively part funding the development and therefore should not lose rights from the eventual commercial success of the innovation. However it can also be argued that consumers benefit from innovation through better service provision and managed distribution costs.

EUA would like Ofgem to review this point to see if there is a way to enable supply chain companies to maintain more control over their innovation.

Our member companies from the supply chain have suggested that approval should be universal rather than sought with each GDN. However on balance this would introduce competition that only benefits the customer in that network, rather than what the GDN's currently do, which is to collaborate and share best practice and therefore the positive outcomes are shared with all customers. A key aspect of NIA and NIC is knowledge dissemination, which the GDN's are doing.

As demonstrated from this response the culture and practice of innovation is complicated and has a number of different answers depending on where a company is within the supply chain, how big they are and what product or service they are providing. Overall all

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companies would recognise that the gas distribution networks are embracing innovation, the same is not consistent across the other sectors. The eight year settlement and the NIC and NIA are all developments that have led to a culture that values and leads to greater innovation. However with a few changes this could be improved on further. For RIIO-2 the supply chain would like Ofgem to revisit to situation around IP ownership and how to encourage greater take up of final products.

A radical move away from the current process could lead to network companies becoming more risk averse.

It was unanimously agreed that Innovation in the water sector hasn't worked, especially on the large scale so members would not want to see that system replicated in RIIO.

EUA will be working with suppliers and the GDN's to provide more quantitative evidence for Ofgem on the success of the innovation stimulus. We hope to be able to feed the results of this work back before the end of the year.

### **33 - Should the plans be revised at any stage during the price control, for example annually?**

EUA members believe that this depends on degree this is implemented. Changing business plans every year has significant risks. The gas network is a long term asset. Raising capital against it is based on the long term value of the network and annual revisions would undermine that.

### **34 - Should we retain fast tracking and if so, for which sectors?**

EUA believes it difficult to assess the benefit at this stage. In principal it's a good idea, but members are undecided as to whether it's the right tool.

There is a concern when looking at the water industry where fast tracking has had decidedly mixed results.

It is agreed that early visibility of plans is good for the stakeholder however the focus on making sure the outcome is fair.

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It was agreed that the better business plan then the better long term certainty. If it left until it later then the skill pool can be diminished. There are plenty of sectors competed for the same supply chain especially with big infrastructure investments planned or underway such as HS2 and Crossrail 2. If too much uncertainty exists over the business plan and its legitimacy then the supply chain may commit itself to other project leaving skill provision gaps. This could be further complicated with Brexit whereby emergency labour may be harder to come by.

Overall the EUA membership view was that the plans shouldn't be reviewed annually.

### **35 - Do we collect the right information in the right format and are there better ways to monitor the performance of companies?**

This industry would like more positive reporting of RIIO and what is being delivered. There is a lack of understanding on what RIIO means and what it delivers. The supply chain and network companies would like better communication of the innovations within the sector and how these have benefitted consumers.

Along with the consumer costs, benefits should be listed as well. It is hard to communicate to consumers and stakeholders if there is an overall lack of awareness and information is disjointed.

It should be noted that overall member companies did not believe there needed to be a better way to monitor performance, just a better way of illustrating it.

We would be happy to discuss any of these points further with Ofgem.

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