30th April 2018

Please reply to:

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Dear Ofgem

RIIO2 Framework Consultation

1. Sustainability *First* is a think tank and charity that works in the energy, water and waste sectors. We have significant experience of consumer and public interest issues, regulation and the demand side (see **www.sustainabilityfirst.org.uk).**

General comments

2. RIIO2, the new price control for energy networks, is important for all stakeholders - current customers, future consumers and wider interests such as the environment - as:

    - Energy is an essential service. It is important that all consumers are able to access energy, including those in vulnerable circumstances, and that as far as possible they have security and peace of mind when things go wrong or there are resilience challenges;
    - The costs involved are significant. In the current price control period, networks will have been allowed to recover revenues of £96 billion over eight years;
    - Bill payers will be paying for current and future investments. In 2017/18, a typical GB domestic customer will have paid £252 out of their gas and electricity bills to cover network costs.[1] This inevitably raises concerns about short and long-term value for money and affordability. Consumers, and their representatives, therefore need to have a say in what they are paying for;
    - Energy networks frequently have long asset lives. Ensuring that the needs of future consumers – and stakeholders that do not always have a 'voice' such as the environment - are taken into account is also important;
    - The energy system is already changing. On top of this, further action is needed to close the emissions gap to the fourth and fifth Carbon Budgets. [2] As more distributed generation comes onto the system, the importance of local and community approaches is increasing. Similarly, as the demand side becomes more important to provide flexibility, price controls need to be set with user expectations and behaviours in mind; and

[1] Ofgem, Open letter on the RIIO-2 framework, July 2017

[2] https://www.theccc.org.uk/publication/independent-assessment-uks-clean-growth-strategy-ambition-action/
[2] https://www.theccc.org.uk/publication/independent-assessment-uks-clean-growth-strategy-ambition-action/

- The smart future must work for all. The needs of *all* consumers need to be taken into account as companies innovate and move to a smarter energy world – if this is going to be a 'fair deal' for everyone – and not just tech savvy early adopters or the more affluent.

3. The consultation document focuses heavily on the financing questions and the options for limiting company returns. While the level of returns made by the companies *is* an important issue for fairness and building trust and legitimacy, it is not the only one for consumers and stakeholders. Sustainability First's work has shown that incentives can bring senior attention – and action - to embed and drive 'culture change' in network approaches and getting companies to focus on the outcomes that are important to stakeholders.

4. To ensure that the needs of current customers, future consumers and wider stakeholders are met in RIIO2, it is essential that the price control framework continues to focus on outcomes and incentives – and that these are clarified sufficiently early to make stakeholder engagement meaningful. Over the last three years, Sustainability First's New Energy and Water Public Interest Network (New-Pin) has identified a range of desirable long-term public interest outcomes for the energy sector (see Figure 1 below): VFM / affordability; quality of service; clean services (including environmental protection and low carbon); resilience; place based well-being; and fairness.[3] These point to the need to balance short term value for money and 'fair returns' alongside a wider set of outcomes to ensure not only fairness within generations but also fairness between generations.

Figure 1: New-Pin dashboard of long-term public interest outcomes in energy and water



Source: Sustainability First, Looking to the long-term: hearing the public interest voice in energy and water, February 2018

[3] http://www.sustainabilityfirst.org.uk/images/publications/new-pin/New-Pin%20Looking%20to%20the%20long%20term%20FINAL%20report.pdf

5. Ensuring that these outcomes flow through the RIIO2 framework 'like the lettering in a stick of rock' should help ensure regulatory and management teams stay focused on what the price control is meant to achieve short and long-term rather than getting caught up in a technical process and the quest to contain current margins.

6. Sustainability First considers that the proposed RIIO2 Framework needs to be strengthened in three key areas: vulnerability; low carbon; and meaningful engagement:

   - **Vulnerability** – The consultation document overlooks the needs of customers in vulnerable circumstances. This is likely to lead to an evaluation of the framework that ignores the question of vulnerability. We consider it is important that Ofgem give an acknowledgement *now* that the forthcoming proposals for the gas and electricity distribution sectors will recognise the importance of continuing with an *explicit* incentive to continue to improve network services for customers in vulnerable circumstances. The new RIIO2 incentives should reflect key lessons from the RIIO1 incentive arrangements – including building upon the positive impacts and outcomes so far – as well as addressing main short-comings. These were highlighted in our recent Project Inspire report.[4] Ofgem should also seek the views of the right stakeholder groups to help formulate the new incentives. We also consider it important to give an explicit acknowledgment in the text of the final framework document that in any future *customer-facing* innovation projects, customers with additional needs should be a clear priority in criteria for project evaluation and for project deliverables, including into BAU.

   - **Low carbon incentive** –The RIIO1 incentives around low carbon are fragmented and as such send a weak and inefficient signal on low carbon in the control. They do not necessarily encourage a joined-up and flexible response from companies in this area. To address this point, Sustainability First is proposing the introduction of a new low carbon incentive for RIIO2. The accompanying **discussion paper** outlines our thinking in this area.

   - **Meaningful stakeholder engagement** – We are pleased to see the focus on giving consumers a stronger voice. However, the proposals are focused largely on different 'structural' models (groups, panels etc). They do not really cover how engagement will shape outcomes and incentives. On the current schedule it would appear that discussion of specific incentives will be covered in the sector specific methodologies which are not due to be finalised until Q2 2019. This is the area that consumers are most likely to be able to contribute to in the development of company plans and hence an early steer on the approach to be taken will be important to allow companies to engage effectively. The consultation paper also does not cover how stakeholder representatives are going to be engaged in the

[4] http://www.sustainabilityfirst.org.uk/inspire/report

crucial discussions on costs of capital. Indeed, the section of the consultation on 'fair returns and financeability' is silent on this issue. As long as discussions in this area are treated as a separate and 'technical' discussion, it may prove challenging to convince the public that returns are in fact 'fair.' The proposals on stakeholder engagement could be further strengthened by setting out Ofgem's vision for engagement (short, medium and long-term) and how stakeholder views need to be appropriately taken into account in BAU activity and board discussions on risk appetite.

7. Thinking in the areas outlined in paragraph 6 needs more work and a greater focus in the final RIIO2 Framework document. This isn't to say that these areas should 'trump' other priorities; rather that unless they are sufficiently recognised in the revised Framework, and the subsequent sector specific methodologies, a strong enough signal is unlikely to be sent that these areas need to help shape RIIO2 business plans. It could also lead to a missed opportunity in terms of not using the review process to communicate with wider stakeholders about what is potentially at stake in the RIIO2 control.

8. A strong outcomes focus can help avoid the trap of seeing competition and innovation, two of the rightly flagged issues in the consultation, as ends in themselves. New-Pin has identified that although market-led approaches can deliver many benefits in the energy sector, competition can struggle to deliver outcomes around long-term resilience, place based well-being and fairness.[5] It has also highlighted the importance of aligning innovation funding and incentives with public interest outcomes.[6]

9. The attached Annex provides more detail on the two areas where we consider there are 'gaps' in the framework consultation; vulnerability and governance. It then provides more detailed responses to individual questions from the consultation document.

10. The accompanying **'Low carbon incentive' discussion paper** sets out our early thinking in the area of environmental incentives. We will be holding a round table to discuss our proposals in this area in the coming month or so.

11. We hope these comments are useful and would be delighted to discuss them further with the RIIO2 team.

Yours sincerely

Sharon Darcy
Director
Sustainability First

[5] http://www.sustainabilityfirst.org.uk/images/publications/new-pin/New-Pin_Market_approaches_workshop_22_Feb_2017_FINAL_REVISED_SLIDE_SET.pdf
[6] http://www.sustainabilityfirst.org.uk/images/publications/new-pin/New-Pin_Innovation_in_Energy__Water_and_Regulation_and_Government_Interventions_FINAL_Discussion_Paper_-min.pdf

Annex - Detailed response

Gaps in the consultation

Vulnerability

1. This consultation is almost silent on the subject of the role of networks in regard to consumers in vulnerable circumstances. In January 2018 Sustainability First launched a major report from our Project Inspire – Energy for all: Innovate for all.[7] Opening the launch, Ofgem's CEO was very supportive of the need to put into practice many of the reports recommendations.

2. The Inspire Report specifically recommended that Ofgem should have a specific vulnerability incentive in RIIO2. It recommended that the approach should ensure that the networks deliver outcomes valued by customers in vulnerable situations and that incentives should be designed to:

    - Encourage collaboration and sharing of information among networks, energy retailers and others
    - Allow for flexibility in innovation
    - Respond to rising standards and expectations not set the bar too low
    - Properly reward those that are delivering impact at a higher level
    - Ensure decision-making by Ofgem on the assessment of companies and allocation of any rewards is transparent and consistent
    - Reward effective, not just 'sparkly' innovations, which are embedded into business as usual practices.

3. We consider that a vulnerability incentive would give a clear signal that customers in vulnerable circumstances need to receive a 'fair deal' under RIIO2 and help ensure that they are not put at risk of being left behind in a smarter world.

4. The Inspire report found that on the networks side, incentives are widely believed by all parties to have had a positive impact, prompting "a sea change of improvements" in how companies support customers in vulnerable situations. While there were some suggested improvements to the approach, most felt that the network regulatory framework had broadly "the right balance between carrot and stick". Incentives were seen to have encouraged a more consumer-centric cultural shift within most network companies.

5. Some of those interviewed for our Inspire report thought it was important to explicitly encourage the joining up of network activity in this area with wider fuel poverty programmes where it can benefit consumers. For both gas and network incentives there was a view that a sharper focus on evaluating the consumer and wider benefits is needed. This includes longer-term benefits and those delivered to the business and other parties.

[7] http://www.sustainabilityfirst.org.uk/inspire/reports

Governance

6. The consultation document fails to mention the role of boards in terms of delivering under RIIO2. In our work for the New-Pin project, we have identified the importance of ensuring the board hears the stakeholder voice – current customer, future consumer and wider stakeholders (such as environmental interests) - in order to achieve change. Ensuring that the board risk appetite is appropriately aligned with the needs of stakeholders was seen as a key way of delivering long-term public interest outcomes.[8]

Responses to Questions

7. We have not sought to answer all the questions raised in the consultation but have provided responses where Sustainability First's work has given us particular insights or where we feel there are elements of the consumer interest that have been over-looked.

Chapter 3 - Giving consumers a stronger voice

Q1. How can we enhance these models and strengthen the role of stakeholders in providing input and challenge to company plans? What are your views on the proposal to have Open Hearings on areas of contention that have been identified by the groups?

8. In order to ensure that consumer engagement adds value, it is vital to look beyond process and different models to the outcomes that need to be delivered. As noted in our covering letter, the consultation paper gives little detail on how engagement will identify outcomes and shape incentives and does not explore how these will be measured.

9. The RIIO 2 framework presents Ofgem with an opportunity to outline how it considers stakeholder engagement needs to evolve over the short, medium and long-term:

    - Short term: the key issues that need to be addressed to ensure that the approach taken to engagement in RIIO2 (in terms of methodologies, incentives, business plan formulation and scrutiny etc – for Ofgem and companies) delivers the desirable consumer / citizen outcomes.

    - Medium term: How *on-going* engagement during RIIO2 is best incentivised and delivered.

    - Longer-term: The vision for engagement and how this needs to evolve to move beyond a narrow cyclical price control and compliance focus to encourage collaboration and co-creation.

10. Early action is clearly needed on the short-term issues but unless the medium and longer-term issues are also taken into account now, in terms of setting the tone, not closing off options etc, companies are unlikely to be able to build out deeper and more meaningful engagement for the future.

[8] http://www.sustainabilityfirst.org.uk/images/publications/new-pin/New-Pin-_Check-list_for_energy_and_water_board_eff.pdf

11. Ofgem's own challenge group could help perform this role. A critical requirement of the group is that it is also responsible for challenging Ofgem's own thinking (as the previous CCG was). This 'critical friend' role can be of significant value when looking at methodologies and approach, systemic issues that impact on all companies in the sector and wider price control communications. Ofgem confirmed at the stakeholder event that this was the intention but it is not clear from the consultation document what role it would play.

12. More generally there are a number of issues – such as assumptions about the future of gas or development of electric vehicles – where it would make sense for Ofgem to set out the assumptions that companies should be making, and the range of scenarios that they should be considering, for that to be underpinned by consumer research and engagement. In some cases differences may be expected between regions (eg reflecting different national policies) but otherwise there seems little point in each company carrying out its own research on what are in effect government policy questions. A central repository of research would be helpful to stakeholder groups and avoid duplication. This would be particularly valuable in the case of relatively expensive research e.g. regarding customers in vulnerable situations, where identifying hard to reach groups can be challenging and more costly. Similarly a lot of horizon scanning work is in danger of being duplicated.

13. Open hearings could play a useful part in the engagement process but enough time needs to be allowed for this to be done effectively. Indeed, early engagement of all consumer panels and groups is important if this is to be meaningful. We note that the timing of the engagement activity, particularly for transmission and gas distribution, is already tight.

14. Whilst Open hearings may add legitimacy to the price review process, unless there is clarity as to what the purpose of the different engagement processes is, and how the different panels and groups' work will fit together, there is potential for confusion along with consultation fatigue amongst stakeholders and the wider public. Any duplication of effort may importantly also not be efficient and could result in significant and arguably seemingly disproportionate resource demands on companies.

15. Open hearings should focus on *where there are areas of outstanding contention*. Any duplication of the roles of the Customer Challenge Group, the Customer Engagement Group and the Hearings could lead to conflicting 'consensus' emerging. Ofgem would need to justify and have a clear process in place to justify why it has taken one consumer or expert community view over another or ignored them all. Where the regulator disagrees with a view this could lead to credibility and legitimacy issues both for Ofgem, and for the expert and consumer bodies involved in the enhanced engagement process (who may have spent months to years developing a view only to have it ignored).

16. The consultation document is silent on how the consumer voice is heard in key discussions on cost of capital. This is a significant gap and will make the task of ensuring returns are seen as 'fair' challenging. Although this is an area that may not be suitable for individual company Customer Engagement Groups to address, it is one where Ofgem's own challenge group should have a clear role and legitimate remit. There could also potentially be scope for Open hearings on this subject.

17. The role of the Board and corporate governance in terms of ensuring that the consumer voice is heard around the Board table receives little attention in the consultation. This runs the risk that engagement is seen purely as a regulatory compliance exercise and may dampen the incentive that companies may have to really embed customer and future consumer views into their on-going thinking. Our research for New-Pin on corporate governance has indicated that a compliance approach can make it more difficult for companies to own their own risks and proactively address these in a flexible and innovative way. [9]

Chapter 4 - Responding to how networks are used

Length of price control

Q2. Do you agree with our preferred position to set the price control for a five-year period, but with the flexibility to set some allowances over a longer period, if companies can present a compelling justification, such as on innovation or efficiency grounds?

18. Given the pace of change it seems reasonable to move back to a 5 year control. The idea of having some cost categories viewed on a longer-term basis makes sense. In the document Ofgem cites the example of mains replacement where, without a longer-term view of costs, there can be incentives of companies to defer the more expensive projects. In such cases it would seem to be in consumers' interests to take a longer view but Ofgem's proposal is that this would only be done where companies make a strong case. We would encourage Ofgem to be proactive in identifying areas where such an approach could be in current and future consumer interests.

19. There are also some real questions about how this would work in practice (given currently companies do not ultimately have allowances for individual cost categories, just an overall revenue cap) but we assume that Ofgem is satisfied that such an approach is practical.

Whole system outcomes

Q3. In what ways can the price control framework be an effective enabler or barrier to the delivery of whole system outcomes? If there are barriers, how do you think these can be removed? What elements of the price control should we prioritise to enable whole system outcomes?

[9] http://www.sustainabilityfirst.org.uk/images/publications/new-pin/New-Pin_-_Board_Governance_Summary_Conclusions_-_FINAL.pdf

Q5. In defining the term 'whole system', what should we focus on for the RIIO-2 period, and what other areas should we consider in the longer-term? Are there any implementation limits to this definition?

20. Encouraging whole system thinking should be an important goal of the regulatory framework and it is important that the price control arrangements do not get in the way of that. These are complex issues and are a reason why the design of incentives cannot simply be left to be worked through in the sector specific methodologies. In some cases changes will be needed to legislation for example to allow gas networks to look at alternative solutions for the provision of heat where a costly upgrade would otherwise be required. Given the time needed for legislative change early thinking on these issues is important.

21. Consideration of these questions can also raise fundamental questions about the scope of the price control. For example, the frequency management services ENWL provided to National Grid were treated as excluded services on which ENW was allowed to earn a return. It is in consumers' interests that the networks are incentivised to provide such services but as they potentially become increasingly important there needs to be a clear framework for that to happen without a risk of consumers paying twice in effect (if both the DNO and SO expect a return).

22. A low carbon incentive as suggested in our accompanying discussion paper could also help drive whole system thinking if applied across sectors.

23. We are mindful of the potential impacts that the charging review may also have on networks and the need to align this with the price control framework to achieve a whole systems approach.

System Operator price controls

Q6. Do you agree with our view that National Grid's electricity SO price control should be separated from its TO price control?

24. The SO control should be separated if the SO is to be independent.

Network utilisation, stranding and investment risk

Q9. What options, within the price control, should be considered further to help protect consumers against having to pay for costly assets that may not be needed in the future due to changing demand or technology, while ensuring companies meet the reasonable demands for network capacity in a changing energy system?

25. It is clear that a different way of thinking about investment – such as real options analysis – will be needed to cope with the increased levels of uncertainty going forwards. Work that ENWL has done has already shown that the use of flexible solutions such as DSR can provide real options value, deferring investment until a tipping point is reached. Ofgem should be looking to the companies to develop new techniques for investment appraisal drawing on these sorts of approaches.

26. However there will always be an element of probability and judgment involved. At some point it would be justified to reinforce the network and at times, when major work is being done it may make sense to build in additional capacity rather than have to go back and dig up the roads again subsequently (particularly so in dense urban areas). As such consumers cannot be protected against ever having to pay for assets that may not be needed. The aim should be for the companies to use flexible solutions where it makes sense to minimise that risk and to have robust processes for making those decisions.

27. If following such a process companies have invested in good faith then they should not face the risk of asset stranding. To do so would be a fundamental change to the regulatory compact and could be expected to have significant ramifications for future investment.

28. There could be a contributory role for Customer Engagement Group in ensuring that the companies have engaged with a diverse range of stakeholders/experts so that they can provide assurance that broad horizon scanning has taken place including with future market entrants and future stakeholders. CEGs could, for example, challenge companies to provide assurance that they have considered a wide range of future scenarios and options and to demonstrate the degree to which their proposed business plan decisions reflect the views identified.

End-use energy efficiency

Q10. In light of future challenges such as the decarbonisation of heat, what should be the role of network companies, including SOs, in encouraging a reduction in energy use by consumers in order to reduce future investment in energy networks? What could the potential scale of this impact be?

29. Energy efficiency is an important strand of energy policy that is too often over-looked and under-valued. It therefore makes sense to actively consider what role networks might play. However problems remain of how consumers finance energy efficiency measures (not dealt with in this response), securing consumer interest and awareness and how to achieve sufficient scale in installations to maximise value for money.

30. If the networks were to be given a role, in our view, this would be better delivered as part of a broader low carbon incentive giving them flexibility to focus on the most efficient ways for them to achieve such savings. Our accompanying '**Low Carbon Incentive' discussion paper** sets out our early thinking in this area.

31. In the recent BEIS consultation the idea of involving DNOs in energy efficiency is presented in the first instance as being linked to the benefits that they secure in terms of avoided investment. While there are potential benefits the consultation fails to draw out the limited extent of such benefits:

- Most of the BEIS consultation is focussed on insulation measures. Insulation will only benefit the DNO if the home is electrically heated (around 2 million homes – under 10%).

- The DNO will only benefit from energy efficiency measures if it is in an area where it is currently facing constraints. These tend to be in very localised areas.

32. The case study presented of ENW is encouraging but focuses on lighting and appliance use not insulation.

33. Thus, while there are instances where the DNO has an interest in energy efficiency, the opportunities are currently relatively limited and the DNOs are already incentivised to some extent to pursue such opportunities by the RIIO framework which drives them to seek out the lowest cost solutions (whether traditional network investment or alternative solutions).

34. DNOs do also have additional incentives in terms of vulnerable customer and stakeholder engagement discretionary rewards which provide an additional incentive on them to look at solutions that target such customers, as well as specific innovation funding (which was the driver for eg UKPN's Energywise helping promote energy efficiency among those in fuel poverty).

35. Looking to the longer term, and depending what role electrification of heat plays in heat decarbonisation, the benefits to DNOs are likely to grow and incentives may well be needed to ensure they play their part in that process while minimising costs. However significant steps towards electrification of heat are likely to be beyond RIIO2.

36. While the DNO direct interest in energy efficiency is currently limited as set out above, the consultation also presents an argument for DNOs taking on a wider delivery based on the idea that they could carry out street-by-street programmes reflecting their regional coverage and have access to lower cost capital with a longer time frame associated.

37. The BEIS consultation cites Denmark and Italy as examples where this approach has been adopted. It should be noted however that in the Denmark context the report that is references talks about the Denmark Utility having consumer contact as being a reason for going down that path. DNOs in GB do not have a day-to-day customer facing capability (unlike in other countries where they are responsible for metering and meter reading for example). In practice therefore the DNOs would simply be sub-contracting others to do this work on their behalf in the same way as generators have done under ECO.

38. Clearly there is scope for requiring the DNOs to take this on and they could be set obligations akin to those imposed on suppliers and generators. However the lessons

should be learned from past energy efficiency programmes and BEIS/Ofgem should be clear that customers would still be picking up the costs of such schemes through energy bills.

39. However such programmes are delivered, they are likely to entail partnerships between energy market actors and other stakeholders. This collaboration may need to be incentivised. The advantage of involving networks in this work is that unlike suppliers, they are likely to have an enduring presence in a local community, can commit to longer-term relationships and, as noted above, can operate on a street by street basis and at scale in a particular geography. These points can help create the social 'norms' that should make energy savings programmes more effective in terms of uptake and behaviour change.

40. Viewed through that lens there would be at least as much logic in placing the obligation on gas DNs as on DNOs. Gas DNs are strongly focussed on the challenges of heat decarbonisation and the idea of a carbon reduction incentive could apply equally to GDNs (including to encourage connection of low carbon gas). The main disadvantage of putting an obligation on gas DNs would be that it could only relate to properties on the gas network whereas, in practice, the greatest financial benefits accrue where the fuel costs are highest which is typically in off grid areas.

41. It is much less clear that the electricity SO should have a role in the provision of domestic energy efficiency. They could however possibly identify areas where constraints could be alleviated through energy efficiency measures but noting the caveats above about the limited potential in electrically heated properties. There could be some opportunities in the industrial commercial sector building on the SO experience running Power Responsive.

Chapter 5 - Driving innovation and efficiency Innovation

Q11. Do you agree with our proposal to retain dedicated innovation funding, limited to innovation projects which might not otherwise be delivered under the core RIIO-2 framework?

Q12. Do you agree with our three broad areas of reform: i) increased alignment of funds to support critical issues associated with the energy transition challenges ii) greater coordination with wider public sector innovation funding and support and iii) increased third party engagement (including potentially exploring direct access to RIIO innovation funding)?

Q13. What are the key issues we will need to consider in exploring these options for reform at the sector-specific methodology stage, including: (i) What the critical issues may be in each sector and how we can mitigate the bias towards certain types of innovation through focusing on these issues? (ii) How we can better coordinate any dedicated RIIO innovation funding with wider public sector funding and support (including Ofgem initiatives such as the Innovation Link and the Regulatory Sandbox)? (iii) How we can enable increased third-party engagement and what could be the potential additional benefits and challenges of providing

direct access to third parties in light of the future sources of transformative and disruptive innovation?

Q15. How can we further encourage the transition of innovation to BAU in the RIIO-2 period? How can we develop our approach to the monitoring and reporting of benefits arising from innovation?

42. We would support the continued use of innovation funding given the challenges facing the sector. This is particularly important for innovations where trials may need to be run over an extended period (including potentially straddling price control periods) and where the innovation necessitates collaboration across and between systems.

43. New-Pin research has shown that it is vital that funding and incentives are used to encourage innovation not just in technology but also in terms of commercial, consumer facing and institutional change, including in areas that may subsequently 'enable' technical developments.[10]

44. Innovation is not an end in itself and funding and incentives in this area should be aligned with the desired long-term public interest outcomes. We are disappointed that given the number of questions raised in this document about innovation there is no reference to the point made in our Inspire report[11] about the need for innovation to benefit customers in vulnerable circumstances. We had specifically recommended that any application for innovation funding should include a statement as to how vulnerable customers could benefit from the project in order to encourage such thinking. Although Ofgem had indicated that they accepted this recommendation it does not seem to have been picked up in this document.

45. We strongly support increased third party engagement and potentially direct access to innovation funding, while recognising the need for collaboration with a network partner to ensure that any trials work in a 'live' environment. For this to be effective, further consideration will need to be given as to how to make a wider group of stakeholders aware of the opportunities in this area and how to incentivise collaboration. Ensuring that access to innovation support, incentives and funding are as transparent, clear and simple as possible – and co-ordinated with elsewhere in government – can help. In addition, while Ofgem has determined that networks should not be able to recoup the costs of bid preparation, enabling third parties to do so should help third parties that may have limited resources to be involved in a project. Giving clear feedback on how funding decisions are made, so these are not seen as subjective and bid teams can learn from their experience, is also important.

[10] See http://www.sustainabilityfirst.org.uk/images/publications/new-pin/New-Pin_Innovation_in_Energy__Water_and_Regulation_and_Government_Interventions_FINAL_Discussion_Paper_-min.pdf

[11] http://www.sustainabilityfirst.org.uk/inspire/reports

46. On monitoring and reporting on innovations, we consider it is crucial that this extends to both success and failures (i.e. not just the benefits). A qualitative as well as a quantitative approach is needed that measures the innovation against a counterfactual and also examines the contribution of innovation towards cultural change – within companies (regulated and non regulated) and within Ofgem itself. Monitoring activity must also include an assessment of any distributional impacts.

47. A careful balance needs to be struck here: monitoring and reporting that is too onerous and bureaucratic may dampen creativity and erode the time and space needed for experimentation; and a lack of oversight may lead to customers paying for ill considered work. A focus on outcomes and learning and disseminating the lessons from innovation activity can help get this balance right.

Competition

Q16. Do you agree with our proposal to extend the role of competition across the sectors (electricity and gas, transmission and distribution)? \ What are the trade-offs that will need to be considered in designing the most efficient competitions?

Q17. Do you consider there are any reasons why our new, separable and high value criteria might not be applicable across all four sectors? \ If so, what alternative criteria might be suitable? Q18. What could the potential models be for early stage competitions (for design or technical solutions)? \ What are the key challenges in the implementation of such models, and how might we overcome them?

48. Our New-Pin project has found that market-led approaches can deliver many benefits across the energy sector.[12] Market dynamism can help increase efficiency, lead to more responsive, diversified and innovative approaches and speedier decision-making.

49. Introducing market-led approaches in sectors characterised by such a strong degree of monopoly can, however, be difficult and presents significant implementation challenges. New-Pin identified four tests that need to be met for market-led approaches to deliver long-term public interest outcomes: low barriers to entry and no / low transaction costs; separable / discrete activities; a good match between asset lives and contracts; and no excessive risks as there will be winners and losers in any contestable activity. The extent to which contestable approaches can be introduced in natural monopolistic activities, meet these tests and deliver net benefits that actually flow back to consumers is likely to be limited.

50. Even if there is a strong case for more competition in a particular activity, it is important to recognise that all markets need frameworks. Given the significant change in the energy system, it's important to focus the effort of introducing these where the net benefits are likely to be greatest. Understanding and preparing for any winners and

[12] http://www.sustainabilityfirst.org.uk/images/publications/new-pin/New-Pin_Market_approaches_workshop_22_Feb_2017_FINAL_REVISED_SLIDE_SET.pdf

losers in advance is important, as is agreeing the market rules, red lines and risk tolerances on things such as price, resilience etc. Agreeing how to measure market health up front can help in these decisions.

51. IDNOs and IGTs are already a source of competition in the distribution network. According to Ofgem's website there are around 1 million consumers attached to IGT networks. It remains unclear whether these consumers have seen any benefit from being connected to a competitive network (and indeed they are potentially disadvantaged). Ofgem should undertake a proper review of how this form of competition has worked in practice to inform its approach going forward.

52. Although we consider that market-led approaches can make an important contribution to secure public-interest outcomes in the energy sector, we would reiterate the point that competition is an end goal in itself. Our New-Pin work indicates that contestable approaches struggle to deliver public interest outcomes in terms of long-term resilience (particularly when this requires a cross-sector approach to tackle systemic problems), place based wellbeing and fairness. In these areas the regulatory framework, along with government interventions, is likely to be just as, if not more, important.

53. It is also important that any competitive framework does not dis-incentivise collaboration where it is in customers or the public interest. It may be that incentives need to actively encourage leadership and collaboration in certain areas e.g. horizon scanning, to deal with systemic risks, innovation to support consumer vulnerability and the wider public interest, so that ideas can be shared as quickly as possible.

54. Competitive approaches are just one of the tools open to regulators to deliver public-interest outcomes. It is important to ensure that in the pursuit of these, the benefits of the 'softer' tools of stakeholder engagement and corporate governance are not overlooked. Although this consultation paper refers to the need to create a stronger consumer voice, as already noted it is silent on the role of boards in terms of meeting the needs of their current customers, future consumers and wider stakeholders.

Chapter 6 - Simplifying the price controls

Our approach to setting outputs

Q19. What views do you have on our proposed approach to specifying outputs and setting incentives? When might relative or absolute targets for output delivery incentives be appropriate? What impact would automatically resetting targets for output delivery incentives during a price control have? Which outputs might best suit this approach?

55. The question of whether relative or absolute targets are appropriate should be considered through the lens of what current and future consumers would expect and what can most readily be communicated. Where possible, the focus should be on outcomes, not outputs, to enable greater flexibility in approach.

56. So for outputs that can be objectively measured and where the consumer experience will reflect that objective measurement then an absolute target can make sense. It is a lot easier to ask consumers what they would be prepared to pay for a certain level of improvement in reliability (measured in absolute terms) than it is to ask what they would be prepared to pay for their company to do better than other companies (where it is unknown how well they will do).

57. Framing the question in that way highlights the problematic nature of relative incentives from both a consumer and a company perspective. To be effective as incentives the company needs to be clear what it needs to achieve.

58. The one exception to this would perhaps be for the stakeholder engagement incentive (and other similar incentives) where performance is judged by a panel. In such cases there is not an objective standard that can be used and the marking of the panel in any event includes a relative judgment. In such cases to be rewarded for being the best performing makes more sense.

59. Automatically resetting targets during a price control may deliver some benefits in terms of keeping up with changing consumer expectations and experience. However, it adds to the complexity – both in terms of explaining to consumers and for companies in judging how to respond (ie they have to take account of both their current incentive and how it will affect future incentives). The impression given is that the purpose of doing this would be purely to try to limit returns. It is important that equal attention is given to what this would do for driving good outcomes more broadly.

60. Customer expectations and experiences are likely to change during the RIIO 2 control period. Given the various advantages and disadvantages of relative, absolute and annually updated targets, it would be helpful for Ofgem to carry out more research into which approach is likely to yield the greatest net benefits for consumers.

Fair returns and financeability

Other finance issues

Q42. In the light of our proposal not to amend, at a price control framework level, our policies for depreciation and asset lives set in RIIO-1 do you have any views or suggestions that you wish to put forward?

Q45. What are your views on each of the options to ensure fair returns we have described in this consultation?

61. It seems slightly surprising that Ofgem is not intending to revisit the depreciation arrangements given the levels of uncertainty and their concerns about consumers not paying for assets that are not needed. Using shorter asset lives would be one way of reducing the risk of stranding. It is also noted that in the RIIO ED1 appeal Ofgem said that it would look again at these issues given some of the anomalies created by its

previous decision to reduce asset lives with the possibility of using a radically different approach being floated during the CMA hearings.

62. On the question of fair returns it is important that whatever approach Ofgem chooses that it does not adversely impact on the incentives that companies have to deliver on the outcomes that matter to consumers. While there has been significant concern about the levels of returns that companies are earning the focus should be on steps to avoid unjustified returns (either as a result of over-forecasting in the business plans or windfalls from factors such as RPEs being in their favour). If companies are earning high returns as a result of genuine efficiency savings or delivering excellent performance then they should be rewarded.

63. Ofgem is already taking a number of steps – reducing the length of the price control and looking at greater use of indexation – which should help avoid unjustified or unexpectedly high levels of returns. They have also flagged – rightly – the need to ensure that in designing incentives companies are not rewarded twice if the costs of delivery are included in the allowed revenues. Incentives should also be calibrated to take account of the value that consumers attach to improvements. Ofgem should consider how far these steps will resolve any concerns they have about ensuring fair returns, before adopting more radical steps that could be damaging to incentives and the broader consumer interest.

64. We note that the proposed approach to achieving fair returns is technically focused. This section of the consultation document is written in isolation from the section on the consumer voice at the beginning. This will make it challenging to ensure decisions in this area are seen as 'fair' by all stakeholders.

65. The context in which this review is taking place is one in which questions of corporate structure, gearing and ownership are already part of public debate. Explaining what fair returns look like in this context will be vital to ensure that the final settlement is seen as legitimate. For this to happen, Ofgem's challenge group and other interested stakeholders should be engaged not only in terms of how risks and rewards should be shared but also on what information is needed in the public domain to ensure sufficient transparency in these areas.

Chapter 8 – Next Steps

Q47. Do you have any views on the interlinkages and interactions outlined in this consultation and those that we will need to consider as we develop our sector specific proposals?

66. Many of the issues that are of most direct interest to consumers are not addressed in this document. Ofgem has not even confirmed the broad output / outcome categories that it expects to use for RIIO – 2 going forwards. If companies are to engage fully on the development of their business plans (ie not just consulting on them once they are

written) then Ofgem needs to be providing more detail on many of the sector specific issues earlier than currently envisaged.

67. In particular it is unclear at this stage how far Ofgem will itself set the incentive framework as it did at RIIO1 – which limits the scope for stakeholders to shape the regime to take account of local priorities. In the water regime the companies can propose their own incentives, informed by stakeholder input. Ofgem has indicated there may be more scope for local priorities to be considered but understanding which broad path Ofgem is going down is vital for the companies in setting up their stakeholder engagement arrangements.