

# Perspective

## RIIO-2: the one before RIIO-3



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Ofgem finalised the RIIO-2 price controls for electricity and gas transmission, gas distribution and the Electricity System Operator (ESO) on 8 December, marking one of the key set-piece events of the energy regulatory calendar. It also issued on 17 December a decision on the framework (the sector specific methodology) for the electricity distribution price control that starts in April 2023, two years later than the price controls for the other sectors.

In this week's *Energy Perspective*, we argue that the price controls are undergoing an important transition as the context in which they operate becomes more uncertain and fluid, particularly in the context of the move to net zero. We look at the drivers of this change and consider some of the consequences for the networks and market participants more widely.

### The (first) one with net zero

Ofgem requires the networks to provide justification for their baseline expenditure at the start of the price control. It also requires cases to be made during the course of the price controls for any additional funds under certain uncertainty mechanisms which allow the price controls to flex as circumstances change.

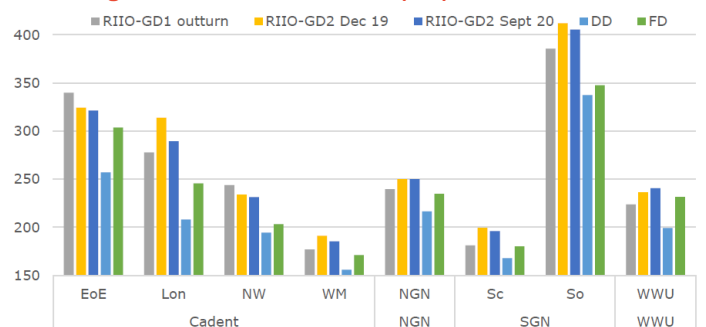
For the final determination, Ofgem increased the overall baseline totex expenditure of the network companies (not including the ESO) to £20.3bn, which is £4.1bn higher than at the draft stage (see Figure 1). Of this, £9.6bn relates to the gas distribution networks, £0.9bn higher than the draft determination and £10.7bn to electricity and gas transmission, £3.2bn higher.

Lack of adequate (as judged by Ofgem) supporting cases at an earlier stage likely played some part in the subsequent increases. While the regulator said it had received an impressive additional 22,000 pages of material since the draft determination, it also levied hefty penalties under the business plan incentive on the two National Grid transmission companies in particular – £26.7mn for electricity and £8.7mn in gas, together with some sharp criticism for systematic failings that “undermined our confidence” in the plans, especially in high value expenditure areas.

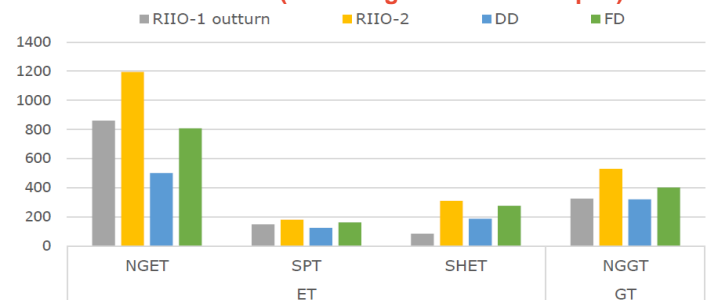
Going forward, the networks must make their cases for further funds under the reopener mechanisms. These can reset the outputs the networks are required to deliver and the allowed revenue they can receive. Such mechanisms will be lent on more heavily in RIIO-2 because of uncertainty around the path to net zero, with Ofgem striving to plot a course that facilitates net zero investment at the lowest cost to consumers.

For reopeners to result in networks responding with the necessary agility to new investment need, this process needs to work effectively and efficiently, with both sides clear on what is required, (something that has not always been the case in RIIO-1, with the Western Isles links an example). The mechanisms comprise some potentially very wide-ranging reopeners, such as net zero reopener across all sectors and the heat

Figure 1: Totex allowances (mn) - Gas distribution



Transmission (excluding load-related capex)



Source: Ofgem

policy reopener for gas. They also include many smaller ones, such as the new electricity transmission Medium Sized Investment Projects reopener for sub-£100mn projects, many of which Ofgem considers may be critical for achieving net zero. To provide the “agility” that is required, and to retain investor confidence requires both regulatory consistency and to match the expected pace of change, timely delivery.

### **The one where Ofgem decides**

The context for Ofgem’s decision making is important as RIIO-2 is likely to require more ongoing regulatory intervention during its course than RIIO-1 due to the unclear path to net zero the regulator is attempting to navigate. This is also in transition, which adds a further element of uncertainty into the mix.

Its headline statement for RIIO-2 is that “it will prepare the regulated network companies to deliver net zero at lowest cost to consumers, while maintaining world-class levels of system reliability and customer service, and ensuring no customer is left behind”. Yet Ofgem does not have a licence obligation to support the delivery of net zero. In the Energy White Paper (EWP) the government set out its intention to introduce a Strategy and Policy Statement (SPS) that will set out the strategic priorities of its energy policy and require Ofgem to carry out its duties “in a manner that is consistent with securing the government’s policy outcomes, including delivering a net zero energy system while ensuring secure supplies at lowest cost for consumers”. While an SPS could clarify choices, there is a danger that it could do the reverse – require interpretation, overlaying and complicating decisions but not providing a full guide to the trade-offs that Ofgem will need to make.

To support its decision process Ofgem requires some clear-sighted, long-term whole-system thinking. In the EWP, BEIS set out its intention to implement a new modelling strategy to improve its insights and increase confidence in policy. Coincidentally (and without explanation or comment) Ofgem recently published a [report](#) by academics which observed that currently the regulator addresses its planning, development and regulatory functions by drawing on the four National Grid Future Energy Scenarios, which were argued to be wholly inadequate to the task in hand. They suggest that Ofgem, either independently or with other parts of government, needs to take more control of the development of the scenarios and consider a much wider range. Developments on approaches to forecasting and modelling could potentially improve the coherence and quality of decision-making, but any impacts in this direction are not yet clear.

### **The one where more things happen**

The energy landscape is never static but currently there are a series of projects and programmes unfolding that will have an impact on the networks and their price controls that further highlight the in-between nature of the RIIO-2 arrangements.

System operation, both at transmission and distribution level, is in a transitional state that is unlikely to be fully resolved by the end of RIIO-2. As a key vehicle to help deliver whole system solutions, the ESO sits in a midway house, having legally separated from National Grid in April 2019 and for the first time subject to a separate price control, but with an ongoing Ofgem review and continued suggestions – most recently in the EWP – that there will need to be greater independence from the current ownership. This is particularly in the context of it taking on additional responsibilities, which include an early competition plan to recommend options for the introduction of early competition in transmission networks, as well as exploring options for a more coordinated offshore transmission system. In the EWP, the government flagged it will consult on system operator arrangements in 2021 as part of a wider review of energy system governance.

In parallel, under RIIO-ED2 there will be greater development of the role of distribution system operator (DSO) as separate from the network operator role, with the relationship between the ESO and DSOs still under development. Ofgem has announced it will be kicking off a strategic DSO work programme in early 2021 noting that the outcome may require it to make changes within RIIO-ED2 to some of the arrangements concerning DSO functions. The final form of these arrangements once defined will impact the role of the networks, the services provided to the system operators and the costs to consumers. Implementing may not be straightforward given shared IT services, for example, and the challenges of separating network operator and system operator functions.

Developments in the offshore regime are in train that will have impacts for the wider regime following the Prime Minister’s Ten Point Plan target of 40GW of offshore wind by 2030. In BEIS’s and Ofgem’s recent [joint response](#) to the government’s open letter on its offshore regime review, the need for coordinated planning across onshore and offshore was noted, as well as the need for a consistent policy and regulatory framework across the whole transmission network. They are setting up a series of workstreams including one on an

enduring regime, for which they intend to consult on design options in 2021.

A sweeping review of the gas arrangements is also in train: in the EWP, the government gave notice of its intention to ensure the gas markets and networks “evolve in a way which enables continued investments and ensures secure supplies but also promotes the use of low carbon options where possible”. It is planning a series of workshops and consultations starting this year on the future of gas, looking at the implications for the networks as well as the wholesale and retail markets and final energy use. The government is looking to review the overarching market framework set out in the *Gas Act*, as well as working with Ofgem to remove “distortions” in the gas market such as reviewing the Domestic Load Connection Allowance for gas grid extensions, rather than allowing competition with other lower carbon options. This may set up changes for RIIO-3 if not sooner.

Then there is the Significant Code Review on Forward Looking Charges and Access that appears to have become mired, with Ofgem unable to set a timetable on when it will deliver its minded-to or final decision. This review is seeking to ensure that the electricity networks are used efficiently and flexibly and the outcome could impact the level of investment that needs to be funded under RIIO-ED2. While intended to be implemented with the price control in 2023, Ofgem is now working out what assumptions the distribution networks should make for their business plans and how it might subsequently adjust the price controls after a decision is made.

### **The one with the inner workings**

Meanwhile, there are developing themes within the price controls themselves. These include the move towards a whole-systems approach. As a construct, RIIO-2 is by its nature fragmented between the sectors, and coordination is not helped by having the ED2 price control start two years after the other ones. While there is a work-in-progress towards whole system approaches in the networks, it is far from fully developed, with Ofgem concluding that business plans in this area generally did not go above the minimum requirements. A new whole-system reopener will enable the reallocating of allowed revenues between companies where they identify a benefit (and is also being introduced in the last two years of RIIO-ED1 for distribution), but the area where most progress appears to be being made is in innovation where the Network Innovation Allowance and the Strategic Innovation Fund are designed to support whole system related projects.

Another axis of development concerns centralisation/decentralisation of approach to planning investment. Strategic investment ahead of need, to prepare for the electrification of heat and transport, is a critical area for RIIO-ED2. Ofgem, having proposed options with varying degrees of decentralised approaches, has decided to opt for a common set of forecast assumptions. It expects the networks to engage fully at a local/regional level, but it remains wholly the distribution networks’ responsibility to make the investment case to Ofgem, although tools such as Local Area Energy Plans can provide supporting evidence. The balance between automatic and other uncertainty measures to flex these plans during the control remains to be determined, while as for the other sectors, a net zero reopener will be included for major changes.

Then there is the issue of network returns. While every price control is a unique event, each one also stands as a development from its predecessor. Given the widely held perception that the companies’ returns had out-turned too high in RIIO-1, the expectation was that Ofgem would seek to lower them, which it has done by dramatically lowering the cost of equity by 40% compared to RIIO-1. It is a moot point whether returns would be this low had it not been for the experience of RIIO-1, but the outturn is a significant shift as Ofgem seeks to tread the line between enabling the companies to finance their activities and ensuring the lowest cost to consumers. If the companies accept this – and there is the possibility of appeals to the Competition and Markets Authority on this or other aspects of the determinations – Ofgem will have succeeded in delivering a major reset of the level of returns that regulated networks can expect.

### **The one with the sequel**

RIIO-2 is a transitional price control between the eight-year long RIIO-1 that made a break with the RPI-X approach as regulatory concerns turned broadly from efficiency to investment, and the next iterations that lay further ground towards net zero – there are probably less than three years until Ofgem starts to work on RIIO-3. This is a more uncertain environment for investors and others as government policy develops and the price controls roll forward, with the regulator taking a more active ongoing role as it seeks to navigate the route forward, placing a premium on the quality and predictability of its decisions. We will be contributing to the debate on these issues over the coming months and addressing the practical implications of what these developments mean for market participants seeking to chart their way through these changes.