

# Agenda

## Advancing economics in business

### Its name is RIIO: a new model for regulating Britain's energy networks

Ofgem, the energy regulator for Great Britain, recently launched RIIO, its new model for regulating Britain's gas and electricity networks. Hannah Nixon, Partner at Ofgem, highlights the objectives and key components of the model and discusses the progress made to date and the challenges to be faced in implementing the regime

Ofgem's Project Discovery estimated that around £200 billion will need to be invested in the UK's energy industry over the next ten years. While most of this investment will be covered by the government's reforms to the energy market, £32 billion of investment is needed in Britain's gas and electricity networks to connect new generation and replace ageing infrastructure.

Although the network component is only a small proportion of the total investment required, it is essential for delivering the benefits from the wider sector investment. It also represents a 75% increase in the existing network asset base and a doubling in the rate of investment. It is not, however, simply a matter of the network companies doing more.

The way energy networks are designed, operated and priced is likely to need to change. In particular, measures to tackle climate change are likely to lead to substantial changes in the way we produce and consume electricity. Networks will need to connect more variable, decentralised generation, and to support consumers to be more efficient in their use of energy, for example by developing smart grid technology. As illustrated by our work on potential future scenarios for the electricity grid,<sup>1</sup> there is considerable uncertainty about the type of infrastructure we need in order to do this. For gas networks, the issues faced are no less challenging. The significant proportion of our CO<sub>2</sub> emissions associated with domestic heating and power generation raises questions about whether these networks will move into managed decline or whether biogas will maintain existing demand for network capacity, or whether new uses will emerge.

Meeting these challenges is likely to require a level of innovation by network companies that is unprecedented, certainly within the last 50 years.

Companies will need to experiment with network design, operation and pricing, in order to connect significant volumes of emerging and untested low- and zero-carbon technologies over relatively short timescales.

To drive these changes to the way networks operate, the way we regulate needs to change. We have therefore launched RIIO, our new model for regulating Britain's gas and electricity networks and the culmination of our two-year comprehensive review of energy network regulation, RPI-X@20.

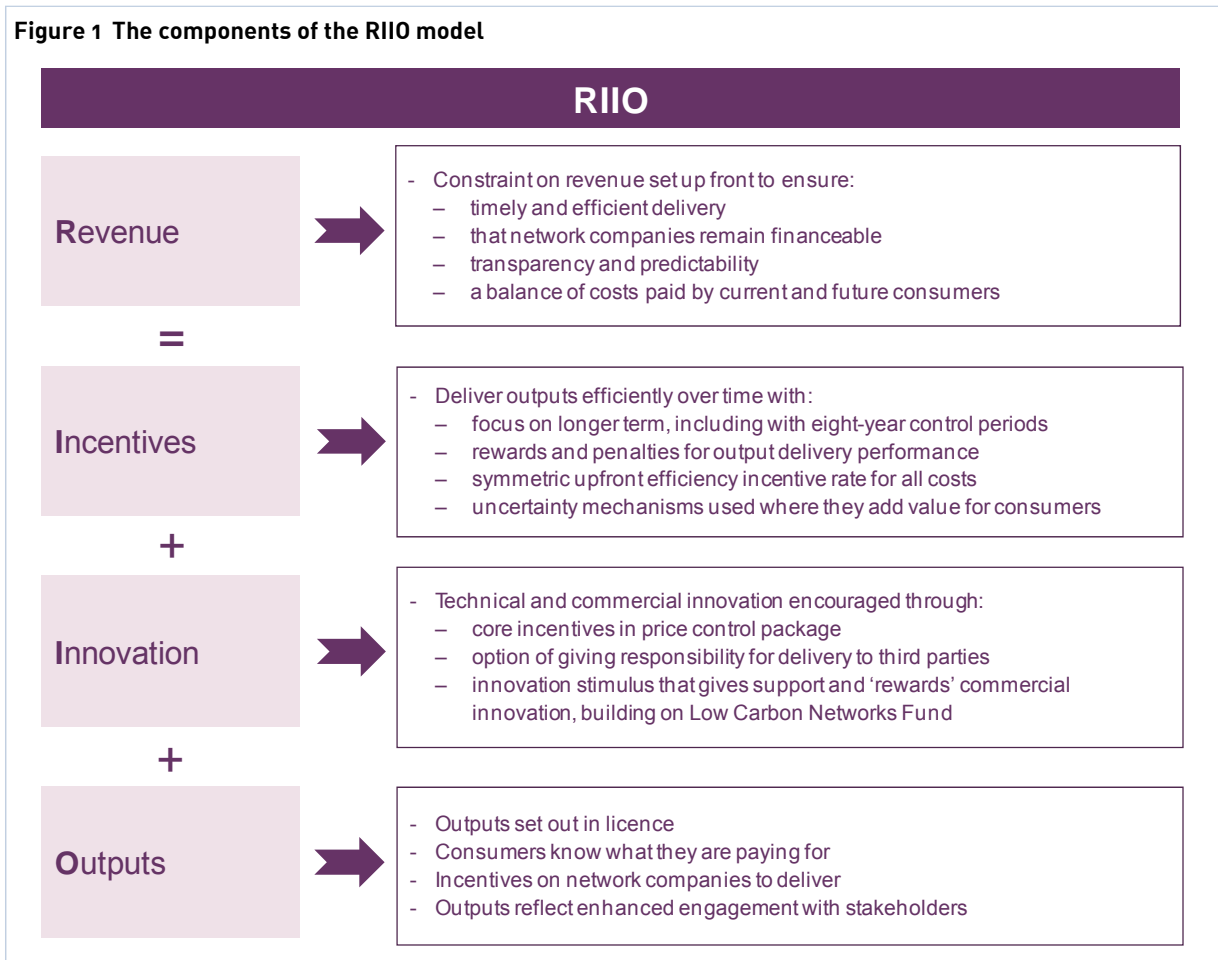
We estimate that the RIIO model could save gas and electricity consumers up to £1 billion in the first eight years of its use.<sup>2</sup>

#### RIIO will deliver

RIIO (revenue equals incentives plus innovation and outputs) is designed to deliver real benefits for consumers. It does this by providing strong financial and reputational incentives to encourage network companies to step up and meet the challenges of delivering a low-carbon, sustainable energy sector at a lower cost to consumers than would be the case under the previous regimes. It puts sustainability alongside consumers at the heart of what network companies do.

The key components of the RIIO model are shown in Figure 1 overleaf. The model builds on the existing RPI – X regulatory framework, retaining some aspects, evolving others and adding new dimensions where required. It follows the principles of better regulation, being more transparent, more accountable, more accessible and more proportionate in its approach. We, network companies and stakeholders, will focus our attention where it is most needed to ensure value for money for today's consumers and future consumers.

Figure 1 The components of the RIIO model



Our board, the Gas and Electricity Markets Authority (GEMA), remains the decision-maker on all aspects of the regulatory settlements for the energy network companies and, in particular, will continue to balance the interests of existing and future consumers. We recognise, however, that making these decisions is becoming increasingly difficult. To maintain the legitimacy and accountability of our decisions, we need to understand fully the needs of stakeholders, allowing them to play a greater role in the decision-making debate and, if they are unhappy with the outcome, making clear how they can challenge our price control decisions. We have therefore published guidance on how we will treat third parties' concerns about our final proposals, including how we will decide whether to modify the proposals and whether to refer the matter to the Competition Commission.<sup>3</sup>

## Implementing RIIO

We, network companies, the industry more widely and other stakeholders, are now focused on implementing RIIO. The next transmission and gas distribution price controls, RIIO-T1 and RIIO-GD1, will be the first to adopt the new framework. We launched the reviews for these in July. Electricity distribution will follow in 2015 with RIIO-ED1.

One of the major implications of RIIO for the price control process is that it front-loads much of Ofgem's work. Our immediate focus is on three areas: engaging stakeholders, determining the outputs that network companies need to deliver, and establishing the parameters for the control period, including the process for achieving a fast-track settlement. The outcomes of this will then feed into our initial strategy document, which will be published in December. This will set out, for consultation, the outputs that companies need to deliver and our views on the shape of the price control, including the process for achieving a fast-track settlement. We will set out our decision on each of these areas in March 2011, in time to inform the companies' business plans.

- **Stakeholder engagement:** RIIO places the onus on network companies to engage effectively with their customers and wider stakeholders and to demonstrate how this will affect the outputs they propose to deliver and their business plans more widely. We are already seeing encouraging signs on this, with a number of network companies setting out and commencing their engagement strategies. However, the real test of success will be whether this engagement demonstrably improves companies' business plans and customer satisfaction.

We are also committed to improving the way in which we engage with stakeholders during the price control reviews. The RIIO model sets out the principles that we will adopt in seeking to engage more effectively with consumers and responding to the views that they express, building on our experiences to date. As part of RIIO-T1 and RIIO-GD1, we are putting significant emphasis on developing and facilitating effective forums for engagement, including open forums, a consumer challenge group, commissioning consumer research and the web forum. These are all drawn together by the Price Control Review Forum, which brings together a relatively small group of stakeholders representing the spread of interests.<sup>4</sup>

- **Determining outputs:** under RIIO we will be setting clear outputs that the network companies will need to deliver. These will reflect the aspects of network services that customers care about—for example, reliability, environmental impact and customer satisfaction. They will be supported by a range of secondary indicators, such as asset health, which we will monitor to ensure that companies are not delivering outputs today at the expense of outputs tomorrow. Some output measures already exist, but others need to be developed. Working groups are already under way, involving a range of stakeholders, to ensure that we have a full suite in place by March 2011.<sup>5</sup>
- **Parameters for the control period:** in order for companies to be able to submit well-justified business plans which could enable them to be fast-tracked, they will need to know ahead of time the key parameters for the control period. The principles, for example around financeability and the use of uncertainty mechanisms, are already set down under RIIO. We will be providing greater detail on these in our March 2011 document. In particular, we will be setting out the structure of incentives for each output and for under- and over-spend, our approach to assessing appropriate notional gearing, how the indexation of the assumed cost of debt will work, an indicative range for the assumed cost of equity, and the depreciation profile. We will also set out the

process for assessing whether companies are offered a fast-track settlement, and conditions for this.

Those companies that provide well-justified business plans and demonstrate a track record for efficient delivery will be offered a fast-track settlement, which will be consulted on in the normal way. For a business plan to be well justified, among other things it will need to demonstrate a clear and well-evidenced case for the proposals, how the views of stakeholders have been reflected, and a clear link between costs and outputs.

If companies are fast tracked under RIIO-T1 or RIIO-GD1, their final price control settlement would be agreed in summer 2011, around a year earlier than would otherwise be the case. For those companies that do not achieve this first time around, our scrutiny will be proportionate to the quality of their business plan and will focus on those areas where we have most concern. Companies that narrowly miss being offered a fast-track settlement will therefore be subject to a lighter-touch regulatory approach than those that are some way behind, with any company submitting a poor-quality business plan being subject to intense scrutiny. Companies that do not achieve fast-track status will be on the same timetable, approximately one year behind the fast-track companies.

In many ways, RIIO is an evolution of our previous approach to regulation, but it is designed to drive major change in the way that network companies think and operate. Those companies that step up to the challenge and demonstrably deliver for consumers will be rewarded, earning healthy returns for their investors. Those that do not will be penalised, seeing lower returns and more intense regulatory scrutiny. They may also face a risk of enforcement action and potential licence revocation.

Implementing any new framework for the first time will always be challenging. However, we are committed to delivering RIIO to the benefit of consumers, and the early signs from the network companies are that the incentives are beginning to drive changes in their behaviour.

## Hannah Nixon

<sup>1</sup> Details of Ofgem's work on long-term electricity network scenarios are available on our website: <http://www.ofgem.gov.uk/Networks/Trans/Archive/ElecTrans/LENS/Pages/LENS.aspx>.

<sup>2</sup> Ofgem's impact assessment is available on our website: <http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/Impact.pdf>.

<sup>3</sup> The basis for this may be influenced by the implementation of the third energy package.

<sup>4</sup> Further information on the Forum is available on Ofgem's website: <http://www.ofgem.gov.uk/Networks/PriceControls/PCRF/Pages/PCRF.aspx>.

<sup>5</sup> Further information on the working groups and about getting involved in the price controls is available on Ofgem's website: <http://www.ofgem.gov.uk/Networks/PriceControls/Pages/PriceControls.aspx>.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Gunnar Niels: tel +44 (0) 1865 253 000 or email [g\\_niels@oxera.com](mailto:g_niels@oxera.com)

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