

Frameworks for future systems and network regulation

Citizens Advice response



May 2023

Executive summary

Citizens Advice agrees with Ofgem on its case for change. In our role as the statutory consumer advocate for energy, the network price controls are an important regulatory process that we engage with as the decisions Ofgem make impact a consumer's energy bill. As natural monopolies it is key the price controls deliver the best value for money. This is to ensure consumers pay no more than they need to and to maintain customer trust in delivering net zero.

With RIIO-2 now completed, it is right for Ofgem to consider both the positive and negative elements of the RIIO process. The introduction of the Future System Operator (FSO) or Independent System Operator (ISO) and potential regional system planners (RSPs) also present a very significant opportunity to do regulation differently. This can ensure consumers get the infrastructure they need to use low carbon energy and at the lowest possible cost. It is essential that net zero is delivered and at the right, appropriate cost to consumers, not at **any** cost.

We contributed to this debate last year with a report¹ on the case for regulatory change that could better deliver a framework suited to the future energy system, and deliver better outcomes for consumers. We believe that this consultation addresses many of the issues we raised. In particular:

- The appropriate use of the different archetypes should allow the framework needs to become more flexible with potentially longer-term arrangements based on adaptive planning
- Whole system thinking and coordination across and within sectors will be better reflected, potentially making use of Regional System Planners and the Future System Operator
- Reforms should make processes less inefficient, time consuming and costly and ensure information is clearer and more transparent

¹ Citizens Advice, [Future Network Regulation: Delivering a regulatory framework fit for the future](#), October 2022

However, there are areas which we think will need more attention in the process which we consider are appropriate success criteria for changes to the regulatory framework:

- **Addressing structural asymmetries.** In addition to the generally recognised information asymmetry, network companies are able to employ more resources in influencing regulatory outcomes than other stakeholders. Coupled with the natural commercial incentive for the companies to seek to maximise returns for shareholders, this means the regulatory process should actively seek to address these asymmetries.
- **Improving and ensuring value for money.** As a result of these asymmetries, there is a considerable weight of evidence that the returns made by network companies are higher than required. This is a result of performance targets being too easy to beat and a failure to reflect the low-risk nature of these businesses in the allowed rates of returns.
- **Defining the role of network companies.** There are areas of price controls which have developed significantly in scope over time. We would highlight the provision of energy advice and support, where we believe these fall outside of the core role of an energy network. We believe that consumer outcomes throughout the net zero transition would be better delivered by a coordinated energy and net zero advice strategy. This would ensure consumers get the independent advice that they need, in the format that they require², and as efficiently as possible.

This response constitutes our emerging thoughts at this stage of the process. We intend to engage in more detail in the workgroups but would note that the short and intensive timeline of this programme presents challenges. This is a timely example of the resource asymmetry outlined above.

² Citizens Advice, [Tackling gaps and overlaps: a discussion paper addressing the energy advice challenge](#), April 2022

Addressing asymmetries

Ofgem recognises that, overall, it is seeking the best way to address information asymmetries inherent in the role of economic regulation. However, we believe there are further asymmetries in resources, commercial incentives and in the current price control processes that should also be addressed. Network companies have a considerable commercial incentive to invest resources (time, personnel, consultancy fees, etc.) into the price control process and have the financial ability to do so.

Resource asymmetry

The regulator, and particularly stakeholders, are at a disadvantageous position with fewer financial and personnel resources to contribute to the process. A simpler framework and better prescribed roles for stakeholder input would make improvements.

However, it is essential that simplification does not come at the cost of robustness as this would be a false economy. Any resource costs in administering price controls are inevitably dwarfed by the overall spending in price controls. Any cost savings in the process will therefore always be significantly outweighed by the additional costs consumers face from less effective scrutiny or poor decisions. It is essential Ofgem has the resources it needs to conduct network regulation under any framework option.

Process asymmetry

The process also needs to better recognise these asymmetries throughout the whole process, including appeals made to the Competition and Markets Authority (CMA), and take actions to redress the balance. Ofgem acknowledged this to some extent in their Open Letter on Future Systems and Network Regulation in September 2022 stating that the RIIO process results overall with a balance of risk which favours the networks. This therefore comes at increased cost and risk to consumers.

This review needs to consider how to better engage non-network stakeholders to address some of the asymmetries explained above. We believe a Network User Expert Advisory Group should be formed. This group could 'shadow' the network company dominated working groups that develop detailed proposals, and provide an effective review and challenge of their proposals.

We also believe that the appeals regime around regulatory decisions requires reforming. Only the regulated companies have effective appeal rights meaning the appeals regime serves to worsen the situation, which is already skewed against the interests of consumers.

Improving and ensuring value for money

Risk and returns

We agree with Ofgem that the framework should ensure consumers get value for money and a fair deal now and in the future. We have previously highlighted that the allowed returns that companies earn for managing consumers investment in the networks has been consistently too high³. We believe that, although Ofgem have reduced returns in RIIO-2, they remain higher than they need to be with Ofgem generously aiming at the higher end of ranges to the benefit of shareholders⁴. The National Audit Office previously reached a similar conclusion in its report into the value for money of electricity networks⁵. This is supported by compelling real-world evidence regarding the premiums that are being paid for network company assets. As a recent example, in November 2022 SSE announced the sale of 25% of its transmission business⁶ at a premium of around 70%⁷ to the regulated asset value.

It is essential that through implementing any changes to the regulatory framework, including potential greater use of archetype 1 and 3, that the correct and appropriate return on investment is delivered. For clarity, Citizens Advice considers the correct level to be sufficient enough to enable companies to attract the necessary funding to manage customers' investment in the network but ensures that consumers pay no more than they need to⁸.

We also recommend that Ofgem explicitly considers throughout this process the effect its decisions have on risk. Our assessment at this stage is that, generally,

³ Citizens Advice, [Monopoly Money](#), May 2019

⁴ Citizens Advice, [ED2 DDs response FINANCE QUESTIONS](#), Aug 22

⁵ NAO, [Electricity Networks](#), January 2020

⁶ [SSE](#), November 2022

⁷ Enterprise value of around £8.5bn (£6bn equity implied by the sale price of £1.5bn for 25%; £2.5bn debt) compared to estimated March 2023 Regulatory Asset Value of £5bn

⁸ For more information - Citizens Advice, [response to UK Regulators Network \(UKRN\) guidance for regulators on the methodology for setting the cost of capital — Consultation](#), November 2022

greater use of FSO-specified work and, in the case of electricity, Ofgem's anticipated increase in demand, and therefore investment and the regulated asset base, provides an extremely secure investment landscape for networks both on the need for investment and the guarantee of returns. We agree that a greater use of archetype 1, as we are already seeing in Electricity Transmission, may be appropriate and that in doing so this would de-risk significant amounts of network investment as the risk and responsibility associated with this is moved from networks to FSO and RSP as licenced entities.

It is therefore essential that any de-risking in this way is clearly reflected when setting the equity beta in the cost of equity calculation. We highlighted in response to ED2 draft determinations that Ofgem had already created numerous mechanisms that enable companies to make investments, including uncertain investments, in a way that protects them against risk. However, the impact of these on the price control is not reflected⁹. This is a key area where future regulation must better reflect the impacts that regulatory approaches have on risk.

Improved representation of stakeholder views is required as this is an example where the resource imbalance between the network companies and other parties is particularly marked. Network companies have an unambiguous interest in the allowed cost of capital being as high as possible as well as having significantly greater resources than stakeholders, including Citizens Advice, to devote to influencing this outcome¹⁰. Active meaningful engagement of other stakeholders is required and Ofgem should give special weight and consideration to the submissions of consumer bodies, in reflection of their common interest with the public interest, their limited resources, and limited regulatory appeal rights.

Incentives

We also believe that the area of incentives, beyond efficiency incentives, will require more attention in this process. We believe that ex ante incentives, in general, have set targets too far in advance and have historically not been stretching enough by failing to reflect the likelihood of outperformance. This

⁹ Citizens Advice, [ED2 DDs response FINANCE QUESTIONS](#), Aug 22

¹⁰ For more information - Citizens Advice, [response to UK Regulators Network \(UKRN\) guidance for regulators on the methodology for setting the cost of capital — Consultation](#), November 2022

results in targets which are too easily achieved and incentive rewards which are too easily earned, as we believe is the case in a number of areas most recently in ED2.

We believe the price control framework should clearly establish the principles behind incentive design for all incentive areas to ensure the outcomes align with the intent.

Price controls are necessary because of the absence of competition and so incentive design should be seeking to replicate the incentives that would naturally exist in a competitive market. This means incentive schemes should be designed to reward those companies that are performing well relative to other network companies (and penalise those performing poorly) rather than against targets set in advance.

We would also note that the National Infrastructure Commission has previously recommended that regulators should allow for the expectation of out-performance against targets by going to the *low* end of ranges regarding the returns these companies are allowed ('aiming off')¹¹. If Ofgem chooses to continue not to follow this recommendation, it is essential that incentive design is reviewed and reformed.

Activities outside the core network role

Lastly, Ofgem and the UK Government, through its review of economic regulation, should establish with stakeholders the roles that networks should and should not play and establish this early in this process. While we agree with Ofgem that networks should undertake work that they are best placed to do, we do not believe that Ofgem has implemented this principle in practice.

Energy and net zero advice strategy

There remain areas of the price control which have developed significantly in scope over time related to providing energy advice and support where we believe these fall outside of the core role of an energy network. We believe¹² that

¹¹ National Infrastructure Commission, [Strategic Investment and Public Confidence](#), Recommendation 5, October 2019

¹² Citizens Advice, [Tackling gaps and overlaps: a discussion paper addressing the energy advice challenge](#), April 2022

consumer outcomes would be better delivered by a coordinated energy and net zero advice strategy. This would ensure consumers get the independent advice that they need in the format that they require, and that this is funded in the most stable and cost efficient way with good data collection and the avoidance of duplication.

The current arrangements also mean energy networks earn many £millions in profits from the allowances paid by consumers which predominantly fund third parties, including charities, to provide these services. We believe that a different approach to funding would be fairer for all energy consumers.

For clarity we believe it is still a core role for energy networks to support customers during interruptions and during energy network processes like connections.

Priority Services Register

We believe there is significant scope to change and improve the way the PSR operates and works for consumers. There is currently too much duplication of effort by networks alongside other regulated utilities to identify these customers. The system should operate on a more sophisticated 'tell us once' basis across multiple sectors to minimise the up front effort from consumers. This would also maximise the opportunity for customers to receive the services and support they are entitled to across a range of sectors, enabling consumers to engage with those companies, products or services¹³.

We support the vision expressed by Ofgem Chief Executive, Jonathan Brearley, in his speech to Ofgem's Vulnerability Summit for a universal PSR¹⁴. We believe this should be pursued as a matter of priority given many years with only modest progress on the topic. Ofgem should set a firm and accelerating timeline for achieving this.

We also anticipate that an operational universal PSR is likely to require material changes to the way that networks, suppliers, and others are regulated in this area if the responsibility is shared more widely and better enables consumers to sign up. It may be necessary to focus regulation on ensuring that data is consistently acted upon, if closing the PSR reach gap and refreshing data

¹³ Citizens Advice, [Getting support to those who need it: How to improve consumer support in essential services](#), October 2020

¹⁴ [Jonathan Brearley's speech to Ofgem's Vulnerability Summit](#), 24 April 2023

becomes less reliant on network companies. Progress on this should therefore be prompt to ensure such changes can be reflected in a new regulatory framework.

Consultation questions

Q.1. What should the role of the 'consumer voice' be and through what institutions and processes should it be channelled?

We welcome that this question is recognised as being an essential element to get right as part of reviewing network regulation. As the statutory consumer advocate for energy, Citizens Advice has engaged very closely with network price controls and experienced first-hand the ways that the 'consumer voice' has been a part of the process, from business planning to decision making. However, we think there is scope to significantly improve this process in the interests of all.

RIIO-2 reflections - business planning

Enhanced engagement

The 'enhanced engagement' arrangements in place for RIIO-2 were a valuable means of aiming to improve the quality and impact of stakeholder engagement. This recognised the value that the stakeholders and customers of network companies can add by having their views reflected in the regulatory process and in scrutinising companies.

However, in practice, we believe that the extensive engagement efforts that have taken place could have delivered greater benefits and been conducted more efficiently.

At the business planning stages, the approaches taken by companies were too varied. In some cases we have observed companies using engagement to build their business plans from the ground up. In others we have seen evidence that engagement has been used to endorse plans already well-developed with little optionality. We have also seen a range of methodologies used including prioritisation exercises, willingness-to-pay research, Customer Engagement Groups (CEGs), User Groups, customer panels and many more.

The outputs of this have generally taken the form of content in business plans and appendices to these plans which, in some cases, have been very lengthy.

Some CEGs also submitted their own views in response to Ofgem's draft determinations.

Impact

We believe a general consensus has developed, as is reinforced in our research¹⁵, that it is not clear to what extent this input consistently impacted business plans or how it affected Ofgem's decision making. We believe there is a strong argument to be made that inconsistent, and in some cases potentially unreliable, methodologies made Ofgem's job of interpreting the evidence and arriving at a set of conclusions extremely challenging.

We therefore believe that RIIO-2 presented two sides of the same coin. On one hand stakeholders and customers have had significantly greater input than previously. On the other hand it is less clear if and where this made significant changes to business plans and, particularly, Ofgem decision making.

Postcode lottery vs regional differences

There is also a tension at play which we believe Ofgem will need to solve under any new regulatory framework. Stakeholder and customer engagement, carried out by different network companies, with support from different consultancies, and with varying methodologies will invariably lead to different answers.

However, network regulation needs to be clearer where revealing differences is useful or not. In some business areas it may be appropriate for there to be regional differences. However, there are also areas where it is unclear why a postcode lottery would be a desirable outcome though it remains, in reality, a large feature of RIIO-2.

One area where revealing differences can be useful is to reveal best practice. Our expectation in RIIO-2 was that the business planning incentive, including the Customer Value Propositions (CVP), aimed to do this to enable Ofgem to level-up business plans across the board in areas like DSO and environmental strategies.

In practice, we saw little evidence of this and the variety of strategies and targets were accepted with little or no amendment. This will mean customers in

¹⁵ Citizens Advice, [Future Network Regulation: Delivering a regulatory framework fit for the future](#), October 2022

different areas receiving different levels of service or performance and at different costs.

Future network regulation needs to be explicit about whether this is a desirable outcome and, if not, regulate in such a way to prevent it. For large parts of price controls, Citizens Advice does not believe different service or performance levels, and the postcode lottery of this, is justified or in consumers interests. The role of regulation should be to ensure customers across GB receive the correct balance of service and performance for the cost, in the absence of this being driven by a competitive market.

Recommendations

Citizens Advice recommends that in areas where regional variation is unlikely to be justified, that stakeholder and customer engagement is conducted centrally or collaboratively. This should be conducted between networks and Ofgem using one common methodology which can include exploring any meaningful regional differences that need to be accounted for.

Where variation is justified we recommend that methodologies to seek the consumer voice are made common to ensure that outputs are arrived at on a consistent and reliable basis. This will ensure Ofgem can have greater confidence that these differences are genuine and in consumers interests overall.

To enable stakeholders and interested parties to engage in these processes, Ofgem should be prescriptive in the information that is required from network companies in the business planning process. This will require that information is consistent, simply presented, and will enable ready comparison across companies or sectors.

The more collaborative approach being taken in the water price control process currently¹⁶ should be reviewed to see what learnings can be applied in energy.

Taking more of a collaborative approach on methodologies is not only more efficient but it could also enable more of a deliberative approach, as was seen in the Climate Assembly¹⁷. This can provide richer insights and ensure that those

¹⁶ Ofwat, [Customer engagement](#), 2022

¹⁷ [Evaluation of Climate Assembly UK](#), July 2021

providing views have a greater level of understanding of what can be complicated and technical topics which often include challenging trade-offs such as cost.

A further step is to employ negotiated settlement as we have seen used by the Water Industry Commission for Scotland (WICS). This is a successful means of establishing real engagement with the consumer in a complex but important process. When we assessed negotiated settlement it was a solution that has the potential to directly address all consumer-related issues we identified¹⁸. However, its strengths may lend themselves to certain areas of network regulation more than others.

The potential regulatory framework changes proposed by Ofgem lend themselves well to the approach of either centralising engagement or ensuring it is consistent. It would enable processes to take place faster and would enable engagement to be conducted in a way that can be tailored to the business area in such a way that maximises its value. This can be on a sliding scale and mean that richer engagement is conducted on areas such as environmental impact, support for customers during interruptions, the speed of connections, and in setting appropriate customer service expectations or appropriate returns and bill impacts. In other areas this could be conducted differently to explore, for example, the topic of cyber security.

Such an approach also dovetails with the roles that the FSO and RSPs would play. Their roles would ensure appropriate regional stakeholder input on future demand forecasting and network need, allowing other topics to be part of a more centralised consumer engagement process.

RIIO-2 reflections - Regulatory development and decision making

Resource and information asymmetries are a particular issue in the development and decision making processes of RIIO-2 price controls. A great deal of development took place on outputs and incentives in working groups where network companies were better able to resource attendance and input compared to stakeholders. Network companies have commercial incentives to

¹⁸ Delta-EE, [Exploring alternative regulation of energy networks and systems. Final report for Citizens Advice](#), May 2022

advocate for frameworks which deliver outcomes which may not be in GB consumers interests overall. The process also encourages consensus among network companies rather than bringing to light differences in opinion, even if this highlights solutions that may be better for consumers.

Future processes must recognise these resource asymmetries and take active steps to redress the balance. We would highlight that the short and intensive timeline in which the FSNR programme is undertaking its work and conducting working groups is at risk of reinforcing these issues with non-network stakeholders less able to engage as intensively.

These issues were also observed in the changes made between draft determinations and final determinations. Generally speaking the balance of changes between these decision points favour network companies, relative to the inputs of other stakeholders.

Recommendations

We believe there are four potential solutions which should be considered:

1. Processes should be less adversarial and involve more transparent collaboration and negotiation
2. Ofgem should involve networks and stakeholders, up front, to establish clearer principles of what is trying to be achieved and the desirable outcomes so that options can be tested against such criteria. This might require greater front-loading of work at the equivalent of the sector-specific methodology stage of the process rather than the latter stages
3. Establish a Network User Expert Advisory Group for each sector, similar to the ESO user group, to ensure that Ofgem facilitates expert stakeholder input and regular feedback during price control setting processes and during delivery. This would ensure the increasing number of interested stakeholders and users of networks have a formal route for inputting directly to Ofgem and assist with rebalancing asymmetries
4. Ofgem should also give special weight and consideration to the submissions of consumer bodies, in reflection of their common interest with the public interest, their limited resources, and limited regulatory appeal rights. In contrast, Ofgem should treat the submissions of

investors – via the companies and their advisers – with caution, in reflection of investors’ very substantial vested interest in the outcome of such regulatory decisions

5. Where the above has been exhausted and legal challenge is necessary, processes should be meaningfully equitable to all interested parties to address the current issues whereby it is considerably more difficult for consumer bodies, than for companies, to appeal against decisions. In practice this would require interested parties to have effective appeal rights that meet the expectations of UK Government¹⁹ which can be used without undue barriers and recognising the extreme asymmetries in resources²⁰.

RIIO-2 reflections - Business plan commitment impacts

We recognise that in RIIO-2 the detail of key RIIO building blocks like ODIs and PCDs have an iterative relationship with business plans. In some instances business plans work within the parameters of clearly defined building blocks. In others the network companies’ input, including through the business plans, have a significant influence on how these building blocks look by final determinations.

We think that changing the regulatory framework brings potential for this process to work more effectively. Greater up-front and centralised consumer engagement in establishing key principles and building blocks of regulation would better define what Ofgem is looking for from networks in the areas where business plans and strategies may still be required. This would provide more certainty and simplify the process for networks while ensuring effort is more targeted.

While business plans can reveal new or innovative approaches, we have seen little evidence in RIIO-2 that this has been a part of a process of identifying these examples and then raising standards to aim all networks towards this. In future,

¹⁹ “The process by which regulator decisions can be appealed should provide appropriate checks and balances to support the right outcome for consumers and the wider public Interest... An effective appeals process ensures that investors, companies, and consumers can be confident that regulatory decisions are made in line with the legal duties of the regulators”. - BEIS, [Economic Regulation Policy Paper](#), Jan 2022, p. 19 and 21.

²⁰ For more information - Citizens Advice, [response to UK Regulators Network \(UKRN\) guidance for regulators on the methodology for setting the cost of capital — Consultation](#), November 2022

where Ofgem wants networks to reveal innovative approaches there must be a clearer feedback loop from these commitments into the building blocks and other targets that Ofgem might set.

RIIO-2 reflections - Ongoing performance monitoring

Citizens Advice believes that ongoing performance monitoring of companies is not stringent enough and that outputs and incentives, while potentially useful, may not always be delivering value for money for consumers.

Comparative company performance

Ofgem should firstly seek better comparative company performance monitoring and reporting. As an example, although Ofgem requires a great deal of data to be published by networks, there needs to be a process where Ofgem identifies the reasons for success and failure, and bring laggards up to the highest standards. Relying on often aggregated performance data may not always be able to provide rich enough insights.

Current reporting and monitoring is largely unseen and relies heavily on outputs and incentives with little regard for business plan commitments that sit outside of these regimes. Ofgem should ensure there are consistent business plan commitment reporting licence conditions across all sectors, consistent with that in place for Electricity Distribution²¹. This condition sets out obligations clearer than what appears to be in place for other sectors. This then needs to be reinforced with scrutiny of this reporting. A league table of business plan commitment progress would be useful.

We have also identified that there is an inconsistency between the data which Ofgem requires to be submitted in regulatory reporting packs (RRP) and the data that Ofgem publishes in annual performance reports. By way of example, the RRP for electricity distribution require each network to report on 400 individual data points each year related to customer complaints including breakdowns of the cause of complaint. However, Ofgem only provides 4 data points in its annual report supplementary data file, none of which provide any breakdowns. The same is true of customer satisfaction where 170 data points are collected with breakdowns by question, but only 3 aggregated scores are published.

²¹ Condition 50 - Business Plan Commitment Reporting

We understand that the data Ofgem publishes relates specifically to outputs and incentives, however, it is clear that Ofgem requires networks to collect and submit a great deal of richer information and data than this. Through greater digitalisation and automation of processes, we strongly recommend that, unless data is genuinely commercially sensitive, that all data required by Ofgem is published in full. We also recommend that this is implemented in all current price controls.

Role of CEGs

Some scrutiny of individual company performance also uses successor groups to Customer Engagement Groups (CEGs). These groups are too variable, can lack independence, and don't have a consistent and clear remit explaining how to best perform this role. Primarily, Ofgem should ensure there is effective ongoing performance monitoring by the regulator. However, in addition to this, CEGs could play an important role. We would recommend that where they do have a role the groups should be mandated independent groups with clear and consistent responsibilities and governance to provide consistent challenge to company decisions and monitor implementation of business plan commitments.

Q.2. How detailed could an independent, cross vector view become to determine future plans for periods beyond RIIO-2 and support effective use of the 'Plan and Deliver' model?

Citizens Advice agrees with Ofgem that the role of the FSO and RSPs is to develop a single view of the truth with the input of networks as well as stakeholders such as local authorities and network user representatives. Given the anticipated input from networks and others, we see no reason why the level of detail in such plans should not be at least as detailed as the plans previously developed by networks. Ofgem should give consideration to whether the FSO and RSPs would need adequate information request powers in order to access commercially sensitive information and data to support this process.

We would expect plans to be able to forecast demand for gas and electricity as well as identifying the most suitable and cost effective whole-system solutions for delivering this, whether this is network build, or alternatives such as flexibility. Where appropriate this would also specify, in the case of gas, where

network is no longer needed to enable price controls to deliver decommissioning or repurposing. While this would involve the input of networks, we anticipate that the FSO and RSPs will require new skills and that, to some extent, this personnel demand may be met by those currently in networks and so may not wholly be reliant on exchanging information.

Q.3. Under what circumstances would competition, or other procurement models such as open book contracting, have benefits over ex ante incentives as a cost control mechanism?

Citizens Advice, generally speaking, welcomes the greater use of either competitive tendering or the outputs of competitive tendering to better achieve lowest cost discovery. This appears to have the greatest relevance in network build projects though may have relevance in network flexibility procurement. We also agree with Ofgem that the decommissioning of any gas network would also be a repeatable activity but with lesser known costs, and therefore could lend itself to competition or models such as open book contracting. We anticipate it will have less relevance in the day to day network operations and maintenance.

OFTO lessons

The evaluations of the Offshore Transmission Owner (OFTO) tender rounds 1, 2 and 3 have demonstrated material benefits to consumers in the range of £683 million - £1.1 billion in 2014/15 prices²² as a result of competition. In total, across all three OFTO tender rounds, the savings as a percentage of the OFTO tender revenue streams are in the range 19-23% for the regulated counterfactuals and 22-31% for the merchant counterfactuals, representing significant savings to consumers.

Given the potential size of network build required and the potential for this to be conducted through a form of competition, as demonstrated by OFTO, the size of the savings to consumers could also be very significant. We therefore strongly urge Ofgem to continue exploring this option wherever it could potentially be applied. The savings to customers through lower returns revealed by this process also further brings into question the relative generosity in returns to companies under price controls.

²² Ofgem, [Evaluation of OFTO Tender Round 2 and 3 Benefits](#), March 2016

Costs where competition is not possible

We understand the argument that competitive processes do take time and may not always be appropriate. However, we believe this is a trade-off that should be made on a case by case basis, most likely based on how quickly constraints in a particular area need to be addressed, as was the case for the Accelerated Strategic Transmission Investment (ASTI). However, this will not be true in all cases.

Change in risk

Where it is necessary that projects, planned for and potentially specified by the FSO or RSPs, are exempt from competition, there must also be a recognition in allowed returns that risk for networks are materially reduced. The risk that network build is not needed or sized incorrectly will be lifted from networks and placed with a different Ofgem-licenced party.

The reduction in risk generally was highlighted as a key contributor to efficient pricing by bidders for OFTO projects and Citizens Advice believes that this principle should also be reflected strongly in future network regulation for onshore networks. Where competition is able to be used effectively, this should also reveal efficient costs which are reflected in competition-exempt project areas.

ASTI issues

We believe strategic investment, with appropriate regulatory treatment, is in consumers' best interests, but there are elements of the ASTI decisions that are likely to be detrimental to consumers. The ASTI programme intends to deliver £19.8bn of network build, more than double the baseline allowances set for the ET sector (£8.8bn). However, the opportunity to input into the structure and mechanisms of ASTI was significantly less than a price control including only a one-month window of formal consultation. While we recognise there can be a need for processes to be quick, there also needs to be appropriate opportunities for input to be given, particularly by those without any commercial incentives, given the material sums of consumers' money involved.

ASTI Accelerated delivery ODI

We believe the ASTI Accelerated delivery ODI is a clear example of where an outcome has skewed to the detriment of consumers, arising from the asymmetries we have previously outlined.

The incentive was put in place to incentivise timely delivery by rewarding or penalising early or late delivery against the target date in order to protect consumers. Despite the incentive having exemptions which protect TOs from experiencing penalties for delays due to circumstances outside their reasonable control, TOs put forward arguments that the balance of risk was not appropriate.

The ASTI decision reflected changes that made the incentive scheme much softer:

- The target delivery date is now the end of the year in which the project is required to be delivered. This is acknowledged by Ofgem as providing *“additional headroom”*.
- The ‘neutral date’, before which delivery earns a reward and after which will be penalised, is now a year later than the target date.

In practice this means that at best, TOs can earn a reward for delivering up to a year late and, at its worst, could earn a reward for delivering 2 years late²³.

We note that 17 of the 26 projects are described as having TO ‘earliest in service dates’ (EISD) which either match (13) or are one year earlier (4) than the ESO’s required delivery dates. Ofgem also considered that TO’s did not provide sufficient evidence that support their view that the EISD dates were stretching targets or have a lower probability of being met.

Ofgem states that it considers *“these changes, along with the other adjustments set out in this Chapter, sufficiently mitigates the risk that the ASTI ODI is asymmetric by design and systematically biased towards penalties”*. It does not, however, consider the risk of systematic bias towards rewards. This is despite the evidence of network companies outperforming targets consistently.

Use of such alternative models in the future will need to ensure the balance of risk in any incentives is balanced and explicitly considers the risk that returns are

²³ Ofgem, [Decision on accelerating onshore electricity transmission investment](#), Dec 2022

too high or rewards too easily achieved. It will also need to ensure that the speed of processes is not at the expense of stakeholder representation.

Competition Proxy Models (CPM)

Finally, we believe this process should look back to models which Ofgem has considered previously, such as the Competition Proxy delivery model which, although not used for Hinkley-Seabank, was considered to have potential use in the future and may be worth exploring again²⁴. We are unclear whether CPM was considered as part of the ASTI process.

Q.4. What is your view on the options identified for simplification of incentive regulation? What would be the benefits and costs by comparison to the approaches used in RIIO-2?

Citizens Advice supports the use of an iterated version of RIIO and incentive regulation for activities that cannot be regulated under archetype 1.

Incentive purpose

At a principle level the aim of economic regulators and the use of incentive regulation should be to replicate the incentives and drivers that would exist in a competitive market which should be in consumers interests overall. We would therefore support Ofgem exploring incentives based on the relative performance between networks. This would be ex-post and could operate annually or periodically as it is not necessarily reliant on fixed price control periods. This appears to most closely align with the model Ofgem describes as *“reviewing efficiency improvements after the fact whilst agreeing ex-ante the structure of the formula by which efficiency would be measured”*.

We agree that this could be simpler up front but may be more complex in close-out processes. However, currently ex-ante incentives and target-setting up front is challenging with networks routinely outperforming or underspending against these at great cost to consumers. As Ofgem notes in their open letter on FSNR, *“the periodic review process requires decisions to be taken before the necessary information is fully available. Previously, this has led to judgements on the allocation of risk which have predominantly turned out in favour of the network*

²⁴ Ofgem, [Hinkley - Seabank: Updated decision on delivery model](#), May 2020

companies". A change towards ensuring networks are incentivised for performance relative to their peers in a way that more closely reflects a competitive market therefore reduces this risk to consumers.

Simplification

It is essential that simplification does not come at the cost of robustness as this would be a false economy. Any resource costs in administering price controls are inevitably dwarfed by the overall spending in price controls. Any cost savings in the process will therefore always be significantly outweighed by the additional costs consumers face from less effective scrutiny or poor decisions. It is essential Ofgem has the resources it needs to conduct network regulation under any framework option.

Archetype 2 implications from 'plan and deliver'

As mentioned, we support greater use of archetype 1. However, there are close relationships between network build and other incentives which will need to be considered. Network planning and design may not be developed by networks, but the delivery of this will impact on areas that networks are currently responsible for such as reliability, worst served customers, and the experience and speed of connecting users/customers. As these are areas covered by incentives where rewards and penalties are intended to reflect outcomes which are attributable to the networks, it is unclear how they would operate under a model of regulation with a greater role played by archetype 1. For clarity, we anticipate that the benefits of archetype 1 would most likely outweigh the practical challenges of working through these implications.

Digitalisation and performance monitoring

We agree with Ofgem that greater digitalisation should enable more frequent or accurate monitoring of performance. We stated in response to Q1 how performance monitoring at present is already collecting large sums of data, but that it is not clear how this data, a fraction of which may be published, is routinely monitored. This is therefore an area where digitalisation and automation of processes may assist Ofgem and stakeholders in understanding and interpreting existing and new performance data.

One point we would highlight, however, is that greater amounts of data such as network digital twins, as Ofgem has highlighted, may rely on more monitoring

equipment to be installed by networks. Ofgem should therefore review whether networks are currently on a path to achieve this or not. For example, in ED2 we are aware that in the area of DSO, network monitoring equipment is rightly seen as only one solution alongside advanced modelling and so may not, in itself, deliver equipment levels required.

Q.5. What are the network activities where there would be benefits for a move to an ex post monitoring regime, and what would be the associated costs?

Citizens Advice does not believe there are areas where archetype 3 'freedom and accountability' would be overall in consumers interests compared to using a combination of archetype 1 and 2. Furthermore, as the FSO is being created and RSPs are likely, it is less clear where archetype 3 could play a meaningful role.

There are also a number of issues which we do not believe would be outweighed by any potential benefits.

Firstly, this method of regulation would lose the totex efficiency incentive mechanism which we believe is an element of RIIO that does appear to work effectively and, we think, would continue to be effective if applied with lower sharing factors. Effective efficiency incentives, unless using competition, provide an important protection to consumers.

We also believe that current performance monitoring could be more effective and so a move to any lighter touch form of monitoring ex-post is unlikely to deliver better outcomes for consumers.

We would also have concerns about the use of suitably high thresholds for disallowing spending in order to address potential network company shareholder concerns. In practice this could allow network companies an inappropriate level of freedom and opportunity to increase the RAB relative to the protections for consumers. Furthermore this model poses a risk to consumers if something is, in effect, too big to be disallowed.

Lastly, this archetype could result in processes becoming debates mainly about the profit margins if it resembles a cost-plus rate of return approach as Ofgem suggests. The role and input of stakeholders, customers, and as mentioned above, the FSO and RSPs therefore looks extremely unclear.

Q.6. What are the benefits and costs of this approach for Electricity Transmission by comparison to an evolution of the approach in RIIO-2, and what are the implementation barriers?

No answer provided

Q.7. What is the potential for Electricity Distribution planning and commissioning to move to an alternative model by the end of RIIO-2, and what might be the benefits and costs of doing so?

No answer provided

Q.8. What is your view on the most effective approach to regulation of Gas Distribution and Transmission beyond RIIO-2? What would be the benefits and costs of moving to a simpler approach to regulation of the ongoing costs of operating and maintaining the network?

No answer provided

Q.9. Should there be a shorter-term price control in gas distribution and/or gas transmission, and how could this work in practice?

Citizens Advice recognises the advantages of aligning price controls, for example if FSO and RSPs focus first on transmission capabilities to enable ET and GT to be reviewed for 2026, and for GD and ED to follow in time for 2028.

We also recognise that reviewing network regulation and setting any price controls for gas transmission, but particularly gas distribution, without adequate foresight of the role of hydrogen and the role of gas networks, is extremely challenging. It poses a risk to consumers that decisions are sub-optimal and are locked in for a period, or arrangements are premised on a significant volume of uncertainty.

While we are open to holding short price controls, it is nevertheless essential that the process for doing so is robust. As a minimum, this requires reviewing

performance across the various incentives (including efficiency) and taking action where general outperformance is found. We would also be concerned about locking in a cost of capital, which is too generous, for a longer period.

Q.10. Would there need to be any changes to maintain a stable and consistent financial framework if we were to make greater use of different regulatory archetypes, and if so, what would those changes need to be?

We recognise that the use of different regulatory archetypes will likely need a different approach to the financial framework. Given the increased use of competition and potential separation of activity, we anticipate that it may be necessary to set different costs of capital for different activities.

However, we do not believe that changes to the regulatory framework necessarily increases risk overall. In fact it is our view that increasing use of archetype 1 significantly de-risks potentially large chunks of investment that networks manage on behalf of customers while still increasing their regulated asset base. We would also note that we consider RIIO-2 to involve less risk than RIIO-1 due to the number of mechanisms that protect against risk but were not reflected when setting the equity beta in the cost of equity calculation²⁵. We would therefore anticipate that an accurate reflection of this further decrease in risk to be reflected in, overall, lower returns.

This is supported by compelling real-world evidence regarding the premiums that are being paid for network company assets. As a recent example, in November 2022 SSE announced the sale of 25% of its transmission business²⁶ at a premium of around 70%²⁷ to the regulated asset value.

Q.11. Do you have any views on our proposed analytical approach?

We broadly agree with Ofgem's analytical framework and welcome that this will involve an impact assessment based on Ofgem's consumer interest framework.

²⁵ Citizens Advice, [ED2 DDs response FINANCE QUESTIONS](#), Aug 2022

²⁶ [SSE](#), November 2022

²⁷ Enterprise value of around £8.5bn (£6bn equity implied by the sale price of £1.5bn for 25%; £2.5bn debt) compared to estimated March 2023 Regulatory Asset Value of £5bn

We would, however, add one area of consumer interest not adequately captured. The framework is rightly focussed primarily on consumer outcomes that are a result of a regulatory process. However, we have set out extensively the problematic asymmetries in RIIO-2²⁸. Addressing this needs to be a key focus in future network regulations and we welcome Ofgem's recognition of this as a result of its focus on exploring the 'consumer voice'.

The consumer interest framework should therefore also include the extent to which the regulatory framework structurally ensures consumers' interests are equitably represented and reflected in processes and decision making, relative to those acting on behalf of shareholders.

Ensuring this interest and input is reflected in decision making has no trade-off as consumer stakeholders have no commercial interest. This should be an explicit success criteria given its alignment with Ofgem's core duty to protect consumers.

We agree that using RIIO-2 is probably the most appropriate counterfactual for assessing options as Ofgem did when assessing the benefits of the Competition Proxy delivery model. However, there is a risk that this assumes that RIIO-2 has produced the optimal answer. It may therefore be useful to include some sensitivities in this analysis, particularly on components such as incentives and components in determining the cost of capital.

²⁸ In this response, [response to draft determinations](#) and in [response to UKRN consultation](#)

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