

Future network regulation

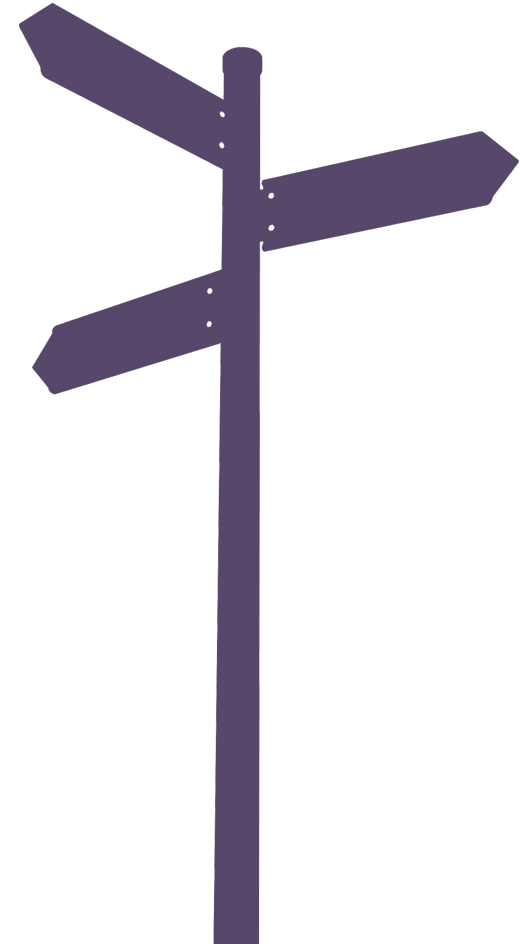
Delivering a regulatory framework fit for the future

October 2022



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Executive summary

Effective network regulation will be key to delivering the network infrastructure needed for a net zero world while still providing value for money for the consumers that are paying for it.

This report has recommendations for the government and Ofgem, the energy regulator, on how to improve the regulatory framework for these network companies so that they can effectively and cost-efficiently manage the pipes and wires that deliver energy to us, and balance the energy system.

This report builds on our research with key stakeholders who provided their perspectives on what works well in the current framework, and what needs to be done to improve shortcomings.

While the current price control framework, known as 'RIIO', is largely viewed as positive, there are changes needed to make it fit for the future. Our recommendations, if implemented, should enable a regulatory system that is more flexible, adaptive to changing conditions, that more fully incorporates consumers' views, and is cheaper and more efficient to run.

Change needs to happen at pace to ensure that consumers rapidly get the services that they deserve at the right cost.

Our 8 recommendations

1

Government needs to give a clear direction to Ofgem through their intended revised Strategy and Policy Statement to meet the net zero transition, to ensure that consumers are at the heart of decisions, and that the most vulnerable are supported

2

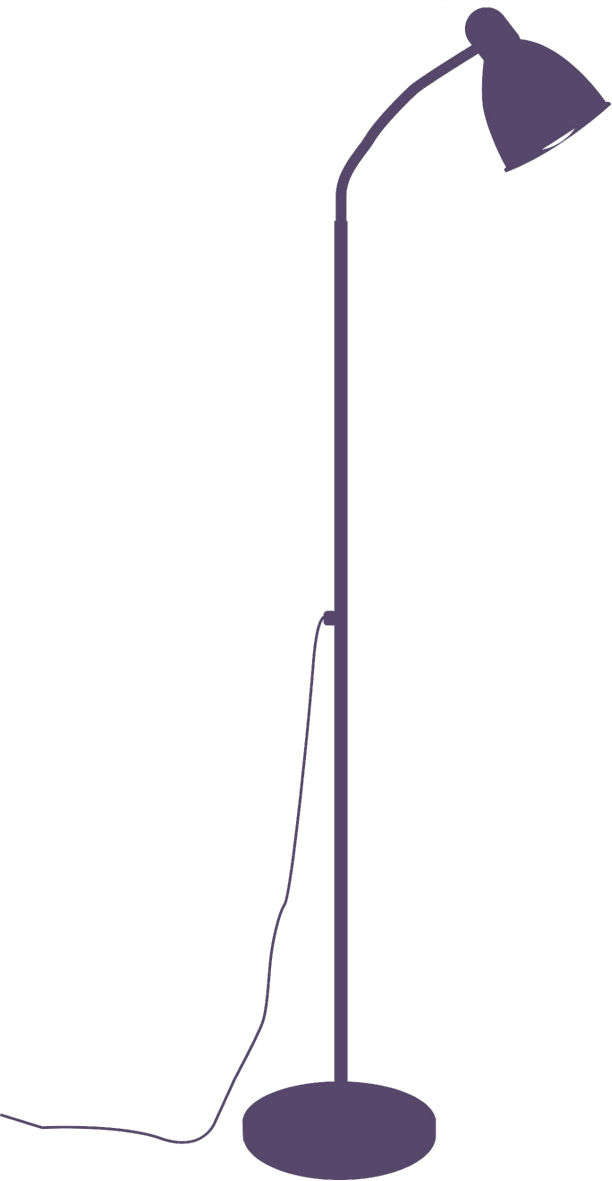
Government should develop a strategy that addresses how consumers, especially those in vulnerable circumstances, are supported. This should look at what support is needed, how it should be delivered, and how it is funded. Efficiency in delivery and fairness should be the priorities for designing the strategy

3

The Ofgem regulatory framework needs to dovetail effectively with the other reforms underway in retail and wholesale markets. Whole-system and cross-sector thinking needs to be incorporated and rewarded

4

Consumer and stakeholder views have to be better incorporated within the process. The ways of collating and using such views needs to be improved so that Ofgem has confidence in applying their insight into decisions



Our 8 recommendations

5

Flexibility has to be built into the regulatory framework to cope with a rapidly changing environment. Longer-term and ongoing price controls using adaptive planning could help steer the early strategic investment needed for net zero

6

Inefficient, time-consuming, and costly processes need to be reformed to speed the decision-making, to make it more transparent, and gain consistency of approach across, and within sectors

7

Improved and rigorous performance reporting needs to be built into the regulatory framework to highlight any shortcomings in companies fulfilling their business plan commitments. This is especially relevant for areas such as reliability, connections, customer satisfaction, and vulnerability support

8

Rebalance the asymmetry between network companies and other stakeholders, including the regulator, which negatively impacts consumer interests. There are current imbalances in resources and knowledge, and a commercial imperative within companies that may not align with the interests of consumers

Key asks: what our recommendations mean in practice

We outline our key asks, who needs to take action, and the positive impacts for consumers

Recommendation	Key asks	Impact
1. Government needs to give a clear direction to Ofgem through their intended revised Strategy and Policy Statement to meet the net zero transition, to ensure that consumers are at the heart of decisions, and that the most vulnerable are supported	Who: Government What: Issue a new Strategy and Policy Statement outlining: 1. An overarching public purpose aim 2. A strong net zero focus	<ul style="list-style-type: none">● Ofgem will be better able to prioritise across sometimes conflicting factors (such as cost concerns versus strategic investment) and should lead to investment clarity for networks and market participants
2. Government should develop a strategy that addresses how consumers, especially those in vulnerable circumstances, are supported. This should look at what support is needed, how it should be delivered, and how it is funded. Efficiency in delivery and fairness should be the priorities for designing the strategy	Who: Government What: Design a strategy to decide how vulnerable consumers are supported (e.g. funded via bill-payers or taxpayers). The strategy should assess what support is needed and delivery mechanisms (e.g. energy and debt advice, energy efficiency measures, social tariffs and financial support).	<ul style="list-style-type: none">● Clarity would be gained for Ofgem and networks in how customers should be supported, and a coherent, fairly funded, and efficient system would be established¹.● Taxpayer-funded solutions could ensure that consumers in vulnerable circumstances receive targeted financial support

Key asks: what our recommendations mean in practice

We outline our key asks, who needs to take action, and the positive impacts for consumers

Recommendation	Key asks	Impact
3. The regulatory framework needs to dovetail effectively with the other reforms underway in retail and wholesale markets. Whole-system and cross-sector thinking needs to be incorporated and rewarded	<p>Who: Ofgem and Department of Business, Energy, and Industrial Strategy (BEIS)</p> <p>What: Price controls need to work with reforms such as the Review of Electricity Markets Arrangements (REMA)².</p> <p>Ofgem needs to build price controls that reward whole-system and cross-sector thinking</p>	<ul style="list-style-type: none">● Long term investment would be facilitated through coordinated thinking and planning using common clearly defined consumer outcomes.● Price controls looking cross-sector (transmission and distribution, Electricity System Operator and Distribution System Operation, gas and electricity, and incorporating water, waste, heating, and transport issues) and using whole-system thinking would ensure coherent and cost-effective decision-making
4. Consumer and stakeholder views have to be better incorporated within the process. The ways of collating and using such views needs to be improved so that Ofgem has confidence in applying their message into decisions	<p>Who: Ofgem</p> <p>What: 1. Be prescriptive in how consumer engagement is carried out by networks and/or carry out centralised research</p> <p>2. Establish a Network User Expert Advisory Group for each sector to provide expert stakeholder input</p> <p>3. Continue a version of Customer Engagement Groups (CEGs) during the period control period</p>	<ul style="list-style-type: none">● Confidence by Ofgem in stakeholder engagement, especially willingness-to-pay surveys, would lead to more consumer-driven decisions● Expert input to detailed reporting requirements, guidance documents, and investment and uncertainty mechanisms would enhance the quality of these activities● Mandated independent company CEGs would provide consistent challenge to company decisions and monitor implementation of business plan commitments

Key asks: what our recommendations mean in practice

There were a range of solutions that were proposed to improve the regulatory regime. The key ones are outlined below.

Recommendation	Key asks	Impact
5. Flexibility has to be built into the regulatory framework to cope with a rapidly changing environment. Longer-term and ongoing price controls using adaptive planning could help steer the early strategic investment needed for net zero	Who: Ofgem What: Longer-term frameworks using new models, such as adaptive planning, should be used to design ongoing and responsive price controls	● Decisions would be taken with a longer-term approach with more certainty on overall investment aims. Earlier strategic investment would be facilitated. Processes would be made more streamlined and efficient
6. Inefficient, time-consuming, and costly processes need to be reformed to speed the decision-making, to make it more transparent, and gain consistency of approach across, and within sectors	Who: Ofgem What: 1. Be prescriptive in the information that is required from network companies in the business planning process and ensure that the information is consistent, simply presented, and will enable ready comparison across companies or sectors. 2. Ensure that only essential information is required and that the information is able to be viewed by all stakeholders	● Companies, stakeholders, and Ofgem will have a more effective and meaningful ability to assess company information, including being able to compare plans. Consumers will save from a more cost-efficient process ● External stakeholders and interested parties will be better able to engage with the regulatory process which will lead to more stakeholder- and consumer-focused decisions

Key asks: what our recommendations mean in practice

There were a range of solutions that were proposed to improve the regulatory regime. The key ones are outlined below.

Recommendation	Key asks	Impact
<p>7. Improved and rigorous performance reporting needs to be built into the regulatory framework to highlight any shortcomings in companies fulfilling their business plan commitments. This is especially relevant for areas such as reliability, connections, customer satisfaction, and vulnerability support</p>	<p>Who: Ofgem What: A rigorous annual performance reporting process needs to be introduced which covers each company's core business plan commitments. This information needs to be publicly-accessible and given appropriate publicity to ensure consumer engagement.</p>	<p>● The minimal and largely unseen current annual reporting process by Ofgem would be improved to provide a comprehensive and meaningful mechanism to assess companies' individual and comparative performance. Consumers would be able to understand how their networks are performing in vital areas such as reliability, connections, customer satisfaction, environment and sustainability, and support for vulnerable consumers</p>
<p>8. Rebalance the asymmetry between network companies and other stakeholders, including the regulator, which negatively impacts consumer interests. There are current imbalances in resources and knowledge, and a commercial imperative within network companies that may not align with the interests of consumers</p>	<p>Who: Ofgem and BEIS What: A review to identify imbalances between the power and resources of network companies compared to the regulator, the statutory advocate, and other stakeholder groups. Consultation to assess how best to redress the asymmetries in resources and abilities which influence processes including price controls and appeals to the Competition and Markets Authority</p>	<p>● Decisions about these networks, which are funded by consumers, will better represent views of those that may be currently unheard or where their views are outweighed by the disproportionate resources that can be brought to bear by network companies</p>

Introduction to the research

Ofgem, the energy regulator, has asked for input on how it should regulate the energy network companies in the future. In anticipation of this consultation, we asked key stakeholders their views on what has worked well in regulating these monopoly companies, and what could be done to improve the framework and processes.

This report shares our findings and gives recommendations to ensure that Future Network Regulation delivers for consumers.



What are energy networks and how are they regulated?

Ofgem regulates companies that build and maintain the pipes and wires that deliver electricity and gas to our homes and businesses. They are called electricity and gas transmission operators (TOs), electricity distribution network operators (DNOs) and gas distribution networks (GDN).

Companies that balance the energy system are also regulated. The main company is the Electricity System Operator (ESO) although DNOs now do localised management in their areas called distribution system operation (DSO).

Network companies are monopolies so need to be regulated to ensure value for money.

Allowed revenues for these network companies are added to consumers' bills.

The cost is about 5% or so on every electricity and gas bill and it can add up to £ billions.

Network companies are regulated through periodic 'price controls' that last a number of years (currently 5 years) and take about the same amount of time to consult upon and decide.

'RIIO' is the name of the current price control framework and refers to Revenues, Incentives, Innovation, and Outputs which have been the building blocks for the price control.

About the research

We asked Delta-EE, a consultancy firm, to talk with a range of stakeholders to identify issues with the current RIIO regulatory framework. We also asked for ideas for solutions to those problems. 16 interviews were held with industry representatives, end-user organisations and charities, and independent experts and academics.

Delta-EE also undertook a review of 3 alternative regulatory models where there were applicable to the regulatory environment for energy in Great Britain (GB). These case studies included a review of the Water Industry Commission for Scotland (WICS), Ofwat's PR24 adaptive planning proposed framework, and the New York Reforming the Energy Vision (NY REV).

Link to the underlying research report

You can read the full Delta-EE report at our website via the link below:

[Delta-EE - Exploring alternative regulation of energy networks and systems](#)

Key research findings

Overarching framework

There was a wide range of views regarding what had worked well with the current RIIO model, and where there were shortcomings. In some cases there were contradictory views. For instance, one source described the RIIO framework as “best in class in Europe” while most rated it as slightly above satisfactory. Even given these assessments, all but one felt it was an effective framework overall.

As might be expected in these interviews, people tended to focus on the negative issues and areas for improvement which included a number of overarching framework issues:

- Ofgem appeared to lack a strategic vision with the result that network companies played the ‘regulatory game’ of satisfying Ofgem rather than being ‘purposeful’ utility companies serving consumers.
- Differences in regions, companies, or sectors may not be accounted for in a centralised framework. Although there was a counter-risk of the risk of a ‘postcode lottery’ of service provision.
- Targets may be set too far in advance and have historically not been stretching enough.
- The regulatory process was too long, bureaucratic, complex, and unnecessarily adversarial.
- Several sources felt that Ofgem may be under-resourced to deliver the current RIIO model.

Key research findings

Fitness for the future

All sources agreed that the RIIO framework's fitness for the future could be improved to better adapt to the rapidly changing environment.

Issues in this section included:

- Lack of agility in the framework to respond to new and evolving developments. Periodic reviews could become a barrier to the energy transition and current uncertainty mechanisms may not be able to deal with "unknown unknowns" that fundamental technological change will bring.
- Failure to fully incorporate whole system thinking, holistic solutions, and coordination across sectors and within sectors. Regulatory silos could limit whole system benefits and a mismatched timings of sector-specific price controls added to this problem.
- Coordination was needed between electricity distribution and transmission, between gas and electricity, and across other sectors, such as water and transport.
- False competition between companies created by the RIIO framework negates sharing of best practice.
- Strategic investment may be delayed although there were cautions raised on reinforcements being used as a means to increase the regulatory asset base.

Consumer and stakeholder engagement

Stakeholder engagement problems were highlighted by a number of the interviewees. Given that the decisions taken by Ofgem and the network companies affects every citizen, including in their bills, their views need to have a central role in the process.

Issues highlighted included:

- Stakeholders did not have sufficient resource to meaningfully engage with the complex RIIO regulatory process. The time resource needed to engage was noted as well as the expertise that was required to understand and input to the price control
- Consumers were also identified as struggling with some of the technical topics, although some felt that consumers could input appropriately if given sufficient information. Concerns were raised about the way that companies were conducting the research that may lead consumers to give company-desired answers
- It was unclear how the engagement findings were used by Ofgem in its decision-making with a feeling that Ofgem distrusted the information provided. Many felt that more guidance or prescription was needed by Ofgem so that there would be more confidence in using the findings
- Customer Engagement Group (CEG) input was not felt to have been listened to by Ofgem
- Some felt that the Challenge Group (CG) was given too much weight and that this was a role that Ofgem should play

Consumer impacts

Any shortcomings in the regulatory framework have consequences for consumers in terms of costs, a focus on the wrong services, delays to relevant services, and failure to reach net zero targets.

Key impacts identified included:

An inefficient, bureaucratic regime that will ultimately cost consumers in terms of Ofgem costs to administer it, network and company resource to provide information, and stakeholder expense to input to the process

Consumer voices may be lost as current methods of engagement are not sufficient to represent every view. High barriers to engagement skew decisions to those stakeholders that can be heard. This will lead to an emphasis on services for those with the loudest voice

Slow decision-making which may impact service-provision for consumers (such as reliability and connections), as well as impacting on reaching net zero goals. Slow processes may also mean networks do not respond rapidly enough to be resilient in the face of climate change

Consumers and stakeholders may not trust the outcomes of price controls given the complexity, bureaucracy, lack of ready ability to input to them, and lack of transparency on how decisions are reached



Suggested solutions from our research

There were a range of solutions that were proposed to improve the regulatory regime. The key ones are outlined below.

Problem	Solution	Impact
Lack of strategic and purposeful focus for the regulatory framework	<p>Who: Government What: Needs to provide more direction to Ofgem, for instance, by issuing an updated Strategy and Policy Statement</p> <p>Who: Ofgem What: Needs a consumer outcomes-based model</p>	<ul style="list-style-type: none">● A clear steer to Ofgem on matters such as net zero, pace of change, and protection for vulnerable customers would help to build a regulatory framework directed to the needs of consumers.● Putting consumer outcomes at the heart of the process will focus upon those aspects most important to consumers and help with difficult trade-off decisions
Structural issues with the RIIO framework such as siloed sectors and relatively short-term price control periods. Bureaucratic, costly processes lacking transparency	<p>Who: Ofgem What: Longer term scenario plans looking cross-sector with shorter review cycles for certain business planning elements. Adaptive planning may be a useful model to use. Consider using other processes, such as negotiated settlement, for some aspects of the price control</p>	<ul style="list-style-type: none">● Processes would be adaptive, less costly and reduce bureaucracy. Appropriate strategic investment would be financed at an earlier point. The framework would be more able to adapt to a changing environment and look holistically for optimal solutions and better incentive mechanisms● This would both streamline the process and incorporate relevant stakeholder views which would improve decision-making outcomes, speed, and transparency
Failure to fully incorporate all relevant consumer and stakeholder views	<p>Who: Ofgem What: Standardise engagement processes and ensure all voices are heard through the use of appropriately-resourced standing groups</p>	<ul style="list-style-type: none">● The services delivered by network companies would fully reflect the needs and wants of every consumer rather than just those that have the resources to be able to input to the process

Case studies 1 & 2

3 relevant regulatory models were examined for this research. While their environments may differ from the GB energy world, there are useful features that may be applicable to the energy regulatory framework. Read the full report [LINK] for further detail on these case studies.

Negotiated settlement - Water Industry

Commission for Scotland (WICS) The economic regulator for Scottish Water, WICS, uses the negotiated settlement model. A consumer forum is at the heart of the negotiation process which sets incentive mechanisms and price controls for the next regulatory period.

Our commentary: The negotiated settlement model is a successful means of establishing real engagement with the consumer in a complex but important process. Outcomes should reflect consumer interests. It may not be suitable for all aspects of energy regulation in the GB given the increased complexity and the need to incorporate whole systems considerations.

Adaptive planning - Ofwat and the PR24 price control Ofwat is intending to have adaptive planning at the centre of the next price control. This process looks to a longer-term core pathway covering a 25 year period, with shorter adaptive pathways to respond to circumstances as they arise. Those trigger points for change should be anticipated and the pathways ready before the circumstance arises.

Our commentary: Adaptive planning is an iterative process requiring consistent monitoring and review points to ensure that the long term strategy remains up to date. It is not yet a proven model for a regulatory framework but could offer advantages over rigid fixed term price controls. Strategic investment may be facilitated with this longer term approach and anticipated change is built into the framework to manage different scenarios. Ofgem's ways of working would need to adapt to this new model as would the network companies and stakeholders to ensure successful implementation.



Case study 3

Next generation performance incentives - New York Reforming the Energy

Vision (NY REV) The REV model places more focus on network companies to evolve to be distributed system platform providers rather than focusing on owning and managing assets themselves. REV uses a Value of Distributed Energy Resources (VDER) model to value and reward the use of such resources. Earning Adjustment Mechanisms (EAMs) were created so that utility companies would be incentivised to achieve the state's key policy objectives. It has a long term goal to create a smart, decentralised, market-based, reliable, and cost-effective system.

Our commentary:

It has not proved straightforward to introduce such a major culture-shifting model. Establishing the VDER has proved contentious and the settling of EAMs has been more time-consuming than anticipated. Key successes, however, include the encouragement of major solar markets and the participation of larger numbers of DER providers. These aspects should improve network resiliency and lead to a more cost-effective system. It may be worthwhile to consider which proven elements of the NY REV could be incorporated into a GB energy regulatory framework.



References

1. [Tackling gaps and overlaps: a discussion paper addressing the energy advice challenge](#), Citizens Advice, April 2022
2. [Response to BEIS's consultation on the 'Review of Electricity Market Arrangements'](#), Citizens Advice, October 2022

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