Our views on the Ofgem RIIO-ED2 Final Determinations for the electricity distribution sector

citizens advice

Caroline Farquhar
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Introduction

This report considers Ofgem's Final Determinations (decisions) for the electricity distribution sector in its RIIO-ED2 (ED2) price control. We have highlighted where decisions are an improvement over the prior RIIO-ED1 (ED1) price control, but we also detail where we believe that Ofgem could have gone further to get better value for money for consumers or better services from the Distribution Network Operators (DNOs). We make a series of recommendations to Ofgem to make in-period improvements for elements of the ED2 price control or to make longer-term improvements for future price controls for these operational elements.

We have focussed this report on Ofgem's decisions which will affect the funding of the DNOs and their services. We have separately addressed improvements for the price control process within our report and blog on Future Network Regulation[1].

Why does ED2 matter?

The six DNOs take the high voltage electricity off the grid and deliver it to homes and businesses across Great Britain. It is essential that these companies deliver in a value for money way as costs are added to everyone's electricity bill. About 5% of each bill are these costs. The sums can be substantial when totalled together. In the ED2 Final Determinations, Ofgem has allowed an initial £22 billion for the 5 year price control period with more allowed if needed.

Ofgem also needs to ensure that the DNOs provide services appropriately in addition to considering the cost and value of those services. These key services include having a reliable electricity supply as well as consumers being able to connect to the network for technologies such as heat pumps, Electric Vehicles (EVs), and sources of generation or flexibility. The DNOs have a vital role in supporting customers during an outage, especially those in vulnerable

[1] Citizens Advice, Future Network Regulation: Delivering a regulatory framework fit for the future, report, November 2022, and Citizens Advice, 'What next for Future Network Regulation?' blog, November 2022

circumstances. Net zero also means that DNOs need to better manage the energy system using so-called Distribution System Operation (DSO) services.

Our summary view of the Ofgem ED2 Final Determinations

ED2 as a whole shows progress when compared with the ED1 price control. The new ED2 framework is more adaptive to a changing environment for electricity demand and supply. Ofgem has also tightened some elements in favour of consumers so that companies are less able to pick up windfall gains or easy wins. But we still think that Ofgem should have gone further for consumers in financial areas such as cost of capital, and believe that incentive targets will again be too easy to beat. Ofgem should have used the opportunity to raise service standards to best practice at the outset of ED2 rather than using monitoring programmes to progress change more slowly.

Key messages on topics where we believe Ofgem could have gone further for consumers:

- Returns to companies are still too high due to Ofgem's cost of capital calculations
- Incentive mechanisms don't reflect a competitive market and it's generally too easy to gain rewards
- ED2 was a missed opportunity to raise standards across the sector. Ofgem did not identify best practice in areas such as Vulnerability, DSO, and in Environmental Action Plans (EAPs). Best practice could have been required by all companies at the outset of ED2
- Ongoing performance monitoring of companies is not stringent enough:
    - Scrutiny of individual company performance 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 do the role

    - Ofgem needs to have much better comparative company performance monitoring in ED2. Ofgem needs to identify the reasons for success and failure, and bring laggards up to the highest standards
- The process to review the new and untested elements of ED2 isn't always clear and some of it is still being developed. Some of the innovative (and welcome) elements in ED2 include uncertainty mechanisms, new incentive structures, strategies for DSO, environmental, and vulnerability topics. Ofgem will need to be alive to respond to what works and doesn't work, and enable changes to be made if necessary.

Read below for our detailed comments and recommendations where we believe improvements are needed.

Detailed views on areas we support in ED2

ED2 framework

Ofgem's framework for ED2 is an improvement from ED1. We support the built-in flexing of allowances during the 5 year price control period. DNOs have been given a baseline allowance that should allow them to meet a realistic net zero scenario for demand. The new ED2 framework then allows for more money to be given via uncertainty mechanisms to meet upturns in demand as a result of net zero goals. The mechanisms can also respond to where demand has been less than expected which is also a welcome design element. We like how Ofgem has provided funding for flexibility services which can be used to avoid investment in infrastructure.

DSO has a much higher focus in ED2 with each DNO being required to develop, and get approved by Ofgem, a DSO Strategy. These strategies have been useful to focus DNOs' minds on using energy management systems, and supporting the development of markets in flexibility services. Consistency in approach to the DSO topic has been achieved by the requirement for a strategy which is good. But we have raised concerns regarding the variability of the details to achieve the strategies which may result in a postcode lottery of services.

Tightened sharing factors for the Totex Incentive Mechanism (TIM)

In ED1, Ofgem aimed to incentivise companies to be efficient by looking for cost savings within those baseline allowances, also known as Totex (total expenditure). Whenever companies saved money by underspending on the Totex, the TIM incentivised the DNO by allowing them to keep a share of the underspend. The rest of the underspend went back to the consumer. During ED1, the underspends for some companies grew to sizeable amounts. Companies were allowed to keep the lion's share of the savings (from around 55% for most companies and up to 70% for one company).

It was not always clear that cost efficiency was the only reason for such underspends in ED1. It was also not easy to recover windfall amounts (for example caused by demand being lower than expected). The Ofgem Green Recovery Scheme has helped to drive DNOs to use underspends during ED1. In ED2, Ofgem has reduced the sharing factor for the TIM down to about 50% for each company, so that there is a better return of underspends to the consumer. The 50% sharing factor may be the right level to incentivise companies. But we know other network companies have lower factors (for example some of the transmission companies have sharing factors of about 35%).

Recommendation: We welcome the reform of the sharing factors for ED2 which should return more funds to consumers in an underspend scenario. But we think Ofgem should review the TIM and its sharing factors again. Ofgem needs to identify if this mechanism is the best way to incentivise cost efficiency. If it is effective, Ofgem should assess what level of sharing factor is needed to drive the right behaviours. It is acknowledged that the sharing factor is a two-way mechanism so that both underspends and overspends are shared with the consumer and this needs to be factored into any review. This review should be undertaken so that any new TIM methodology is established in advance of the electricity and gas transmission, and gas distribution price controls.

Detailed views on where Ofgem could have gone further for consumers in ED2

Cost of capital

This topic is a regular complaint area for Citizens Advice. We still think that the methodology that Ofgem is using allows returns that are too high. There are at least £1.5 billion of excess returns going to DNOs in ED2 using Ofgem's own cross-check figures in the Draft Determinations.

Recommendation: The UK Regulators Network (UKRN) should revise its methodology for calculating cost of capital. Read our detailed recommendations to the UKRN[2].

Incentive mechanisms

These mechanisms are an important part of ED2 to focus DNOs' attention on key areas (such as reliability, support for vulnerable consumers, customer satisfaction, and DSO, for instance). We support their use, but have concerns about the way they work. In a competitive market, you would expect to see winners and losers. But there is a high likelihood of many or all companies earning financial rewards across many of the incentives. We are also concerned that the calibration of some of the incentive mechanisms means that financial rewards will be achieved too easily. In some instances we can foresee that these rewards will be paid out for performance which is no better than that being achieved today and where rewards have already been earned.

Recommendations: Ofgem needs to monitor whether the size of rewards earned are justified and in consumers' interests. In future price controls, Ofgem should set out clearly, and early in the process, what the incentives should and shouldn't do. These principles should then be used to ensure incentives are developed to meet these aims. For example, we believe that only performance

[2] Citizens Advice response to UK Regulators Network (UKRN) guidance for regulators on the methodology for setting the cost of capital, November 2022

that is good, relative to other companies, and improving should be rewarded. The principles should include the areas to cover under an incentive mechanism, and what the aim of the incentive should be (for example, deciding between rewarding absolute performance or relative performance). Once the principles are worked out, the calibration of the incentive mechanisms should flow more easily. It may be too late to introduce changes for ED2. But the price control review for the electricity and gas transmission, gas distribution and Electricity System Operator companies starts soon, and the incentive mechanism principles need to be worked out for them.

Best practice service standards and ongoing performance monitoring

Raising standards across the ED2 sector could have been better achieved by Ofgem during the price control consultation process. We pointed out the variability in plans and strategies proposed by companies, and that such variability wasn't justified by DNOs or Ofgem[3]. We feared that consumers would get different levels of service depending upon where they lived. We were concerned that best practice was not being identified by Ofgem and not required to be included within plans and strategies of all DNOs. It may be too late to ask Ofgem to review the Vulnerability Strategies, DSO Strategies, and EAPs again. But it isn't too late to use performance monitoring to identify and encourage best practice.

Ongoing performance of companies during the price control is not coherent or stringent enough. In ED1, there was insufficient scrutiny by Ofgem for individual or comparative company performance[4]. There was a high reliance on the incentive mechanisms to drive behaviours in the right direction for consumers. Limited effort appeared to be made by Ofgem to identify why some companies performed better or worse than others, or whether rewards were justified and proportionate. That information could have been used to amend incentive

[3] Citizens Advice response to the Ofgem RIIO-ED2 Draft Determinations consultation, August 2022
[4] Ofgem ED1 Network Performance Summary 2020-21 as an example of a current Ofgem comparative performance monitoring report

mechanisms and to raise standards across the sector by highlighting best practice. A company could choose not to chase a reward under the incentive mechanism. The result would be that consumers would get a service languishing behind other areas. The incentive mechanisms also did not cover many business plan commitments and these did not get appropriate independent scrutiny.

Recommendations: Ofgem needs to establish a formal and rigorous comparative performance monitoring framework including qualitative assessment. This monitoring should identify why some companies succeed and others don't. Feedback to companies needs to be rigorous to ensure that laggards use best practice to bring them up to standard. Annual league tables using a RAG rating would be useful to highlight progress.

Role of Customer Engagement Group (CEG) successor bodies

Ofgem has asked companies to continue to use a form of the CEGs during the ED2 price control period. These successor CEGs are intended to provide independent scrutiny of business plan commitments. We support the enduring role of successor CEGs. But we have concerns about the lack of a consistent remit and design for these groups. We warned Ofgem of the risks from having variable successor groups such as inconsistent or poor levels of scrutiny. In fact, the majority of stakeholders that responded to Ofgem on the matter had the same worries.

The CEG successor groups are indeed variable. Some have been blended with business planning duties for electricity transmission. It is not clear that they will have the time to devote to both the ED2 scrutiny and to the forthcoming transmission business planning process. Some DNOs are using existing panels to undertake the scrutiny of ED2 business plan commitments. It is not clear that these panels will be independent enough or resourced to do the role. Dedicated expert members should be used for the detailed work involved in holding DNOs to account.

Ofgem's comparative performance reporting process also needs to have a higher focus. ED1's performance monitoring was inadequate to drive appropriate behaviour change. It could be the same in ED2, unless sufficient resources and processes are put in place to improve matters.

Recommendations: Ofgem should assess the successor CEGs and look at their remits, resourcing, and levels of independence. Ofgem should mandate for sufficient resources, independence, and expert input within the successor CEGs.

New and untested elements of ED2

These new and largely positive elements include uncertainty mechanisms, revised incentive regimes, and new reporting requirements for Vulnerability, DSO, and EAPs. The process to monitor the effectiveness of newer elements of ED2 is not always clear and still under development in some cases. Ofgem will need to use the checks and balances or review points that they have built into the new mechanisms to ensure that ED2 is effective in achieving its aims.

Recommendations: Ofgem needs to be alert to ensure that ED2 is delivering for consumers as expected. Unintended consequences will need to be identified and corrections made to ensure that consumers receive the services that they need, and at the right cost.

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