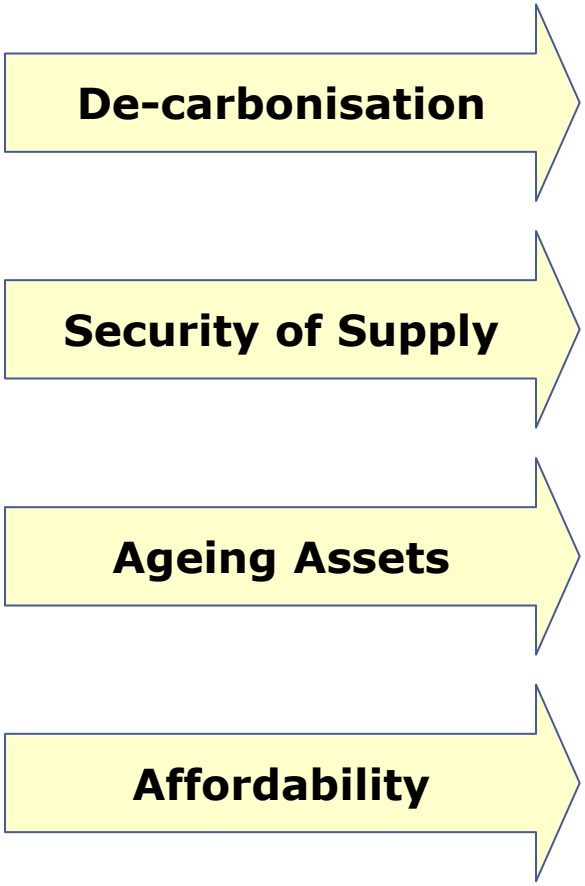
The RIIO model and its implementation in the UK

Ibero-American & European Energy Regulators

27 February 2013

Introducing the RIIO framework

The industry is facing unprecedented change

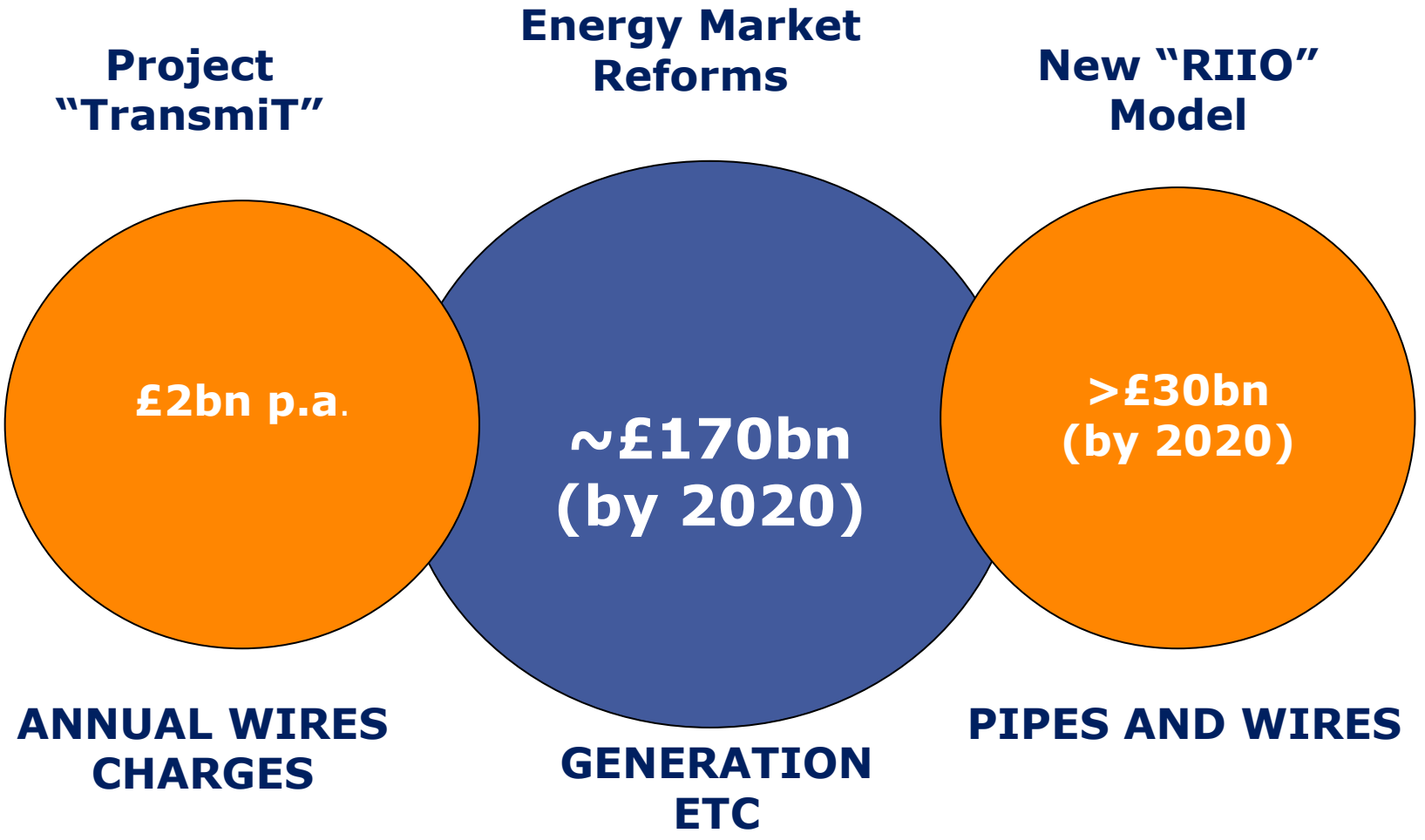


ELECTRICITY NETWORKS

GAS NETWORKS

- **Renewables / new generation**
- **Smart Grids**
- **Electricity storage**
- **Electric vehicles**
- **Different network patterns**
- **Electrification of heat**
- **Energy efficiency**
- **Local generation**
- **Demand Side Management**
- **Carbon Capture and Storage**
- **Biomethane**
- **HVDC**
- **Skills shortages**

The scale of the challenge



What are we seeking to achieve?

Desired outcomes

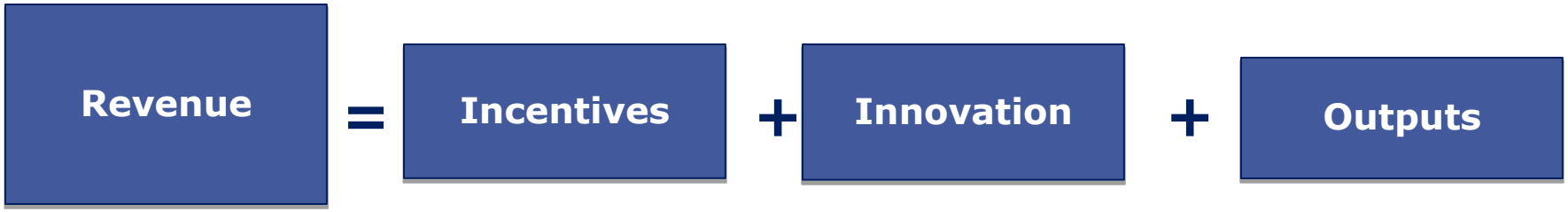
Energy companies to play a full role in the delivery of a sustainable energy sector

Deliver long-term value for money network services for existing and future consumers

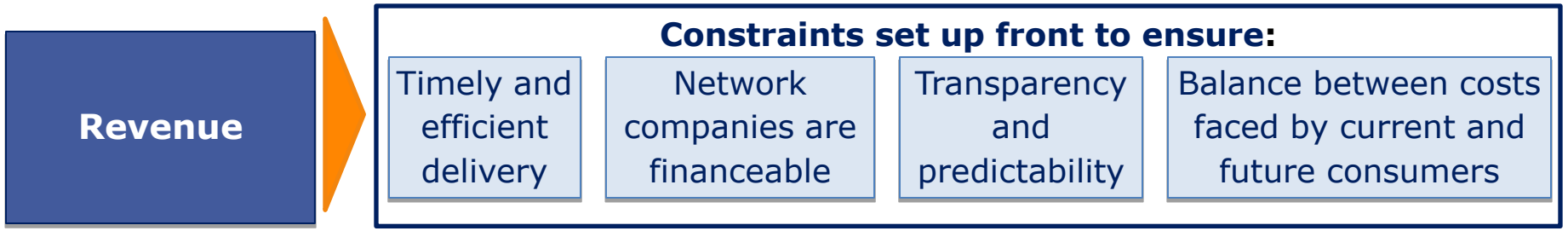
What is required of energy companies to achieve this?

- Long-term focus on value for money
- Innovation
- Optionality and flexibility
- Working with others to identify best delivery solutions
- Understanding and responding to needs of existing and future consumers

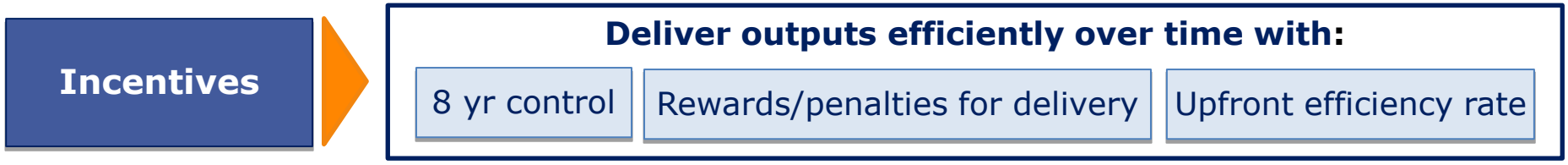
RIIO: A new approach to Network Regulation 1



RIIO: A new approach to Network Regulation 2



RIIO: A new approach to Network Regulation 3



RIIO: A new approach to Network Regulation 4

RIIO: A new approach to Network Regulation 5

Outputs

Outputs set out in clear 'compact', reflecting expectations of current and future consumers

Financeability: Our duty

Our financeability duty

- **Ofgem's Principal objective:** to protect the interests of existing and future consumers
- Must also *"have regard to the need to secure that licence holders are able to finance the activities which are the subject of obligations on them"*

- In the interest of consumers that efficient network companies can secure finance in a timely way and at reasonable cost to facilitate their regulatory obligations
- No bail-out if financial distress is due to own behaviour
- No reward of inefficiency or unwarranted returns
- Capital structure remains the responsibility of network companies' management

Regulatory commitment provided through transparency and predictability
Transitional arrangements to avoid sudden impact on earnings and cash flows

Implementing RIIO

- Electricity Transmission
- Gas Distribution
- Electricity Distribution

RIIO-T1: Electricity Transmission - Key challenges

Level of required investment

- The need for significant investment in the networks. Challenge of facilitating required investment while ensuing that both existing and future consumers get value for money.

Addressing uncertainty

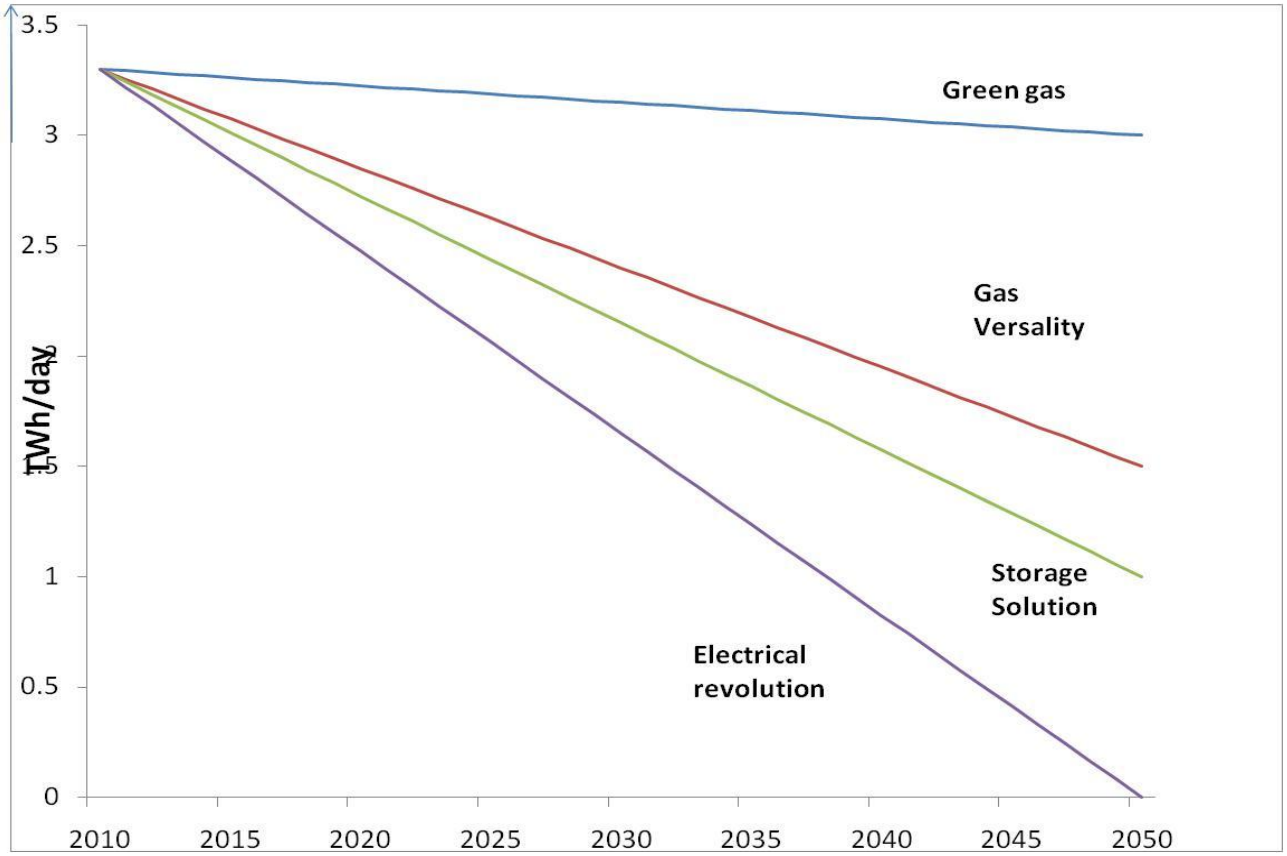
- Significant uncertainty over basis on which some investment would come forward and the associated costs. The need to put in place mechanisms that allow for flexibility to address the uncertainty during the RIIO-T1 period.

RIIO-T1 Final Proposals

- Final proposals provides funding for around £27bn of investment.
- Dealt with the uncertainty by providing uncertainty mechanisms. Basically 2 types:
  - portfolio approach: Provide upfront funding for investment. TO manages risk around volume, timing and cost. Works well where a portfolio of fairly homogenous potential projects. Majority of NGET control funded in this way.
  - incremental funding (strategic wider works): Set up front parameters of funding decision, e.g. rate of return, risk sharing, but decision on precise funding level triggered when project is known. Works well when have a handful of very large projects which are not homogenous. SHETL mainly funded in this way.

Gas Distribution: uncertain future gas flows[1]

- Need to consider optimal investment strategy under uncertainty



Source: Redpoint (October 2010) Gas Future Scenarios Project, page 32

RIIO-ED1 Key Challenges 1

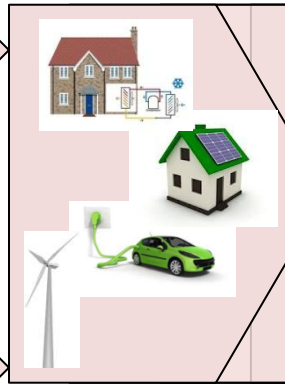
Driving factors

- Feed-in tariffs
- RHI
- Other incentive mechanisms
- Local planning rules
- Technological developments & reductions in cost

Facilitating factors

- Investment to expand and reinforce the distribution network
- Greater use of smart grid technology & DSR to maximise network flexibility at minimum cost

2020 targets



uncertainty around the characteristics, rate and location of take-up of these technologies

ED1 **ED2**

standard asset life

RIIO-ED1 Key Challenges 2

Issues to consider for ED1

DNO approach to developing business plans – scenarios and investment justification

Outputs DNOs are required to deliver – longer term?

Barriers to DNOs adopting commercial arrangements to manage demand and generation output

Incentives and uncertainty mechanisms

Ensure low carbon technologies can connect in appropriate time at appropriate cost

RIIO – So far so good

First price controls under RIIO have achieved:

- ✓ Fundamentally changed behaviour and Board discussions at companies
- ✓ Significant step-up in stakeholder engagement to present well thought-out, detailed and better justified business plans
- ✓ Ofgem staying true to RIIO principles:
  - ✓ Framework and key parameters clearly set out early on
  - ✓ Transparency of approach from early on– No 'black box' dates
  - ✓ Increased stakeholder engagement – including investors
  - ✓ Proportionate treatment
    - ✓ Higher level of scrutiny focused on areas not well justified
    - ✓ Two Scottish TOs fast-tracked
  - ✓ Flexibility in allowed costs ensure customers pay only for necessary expenditure
  - ✓ Financeability not compromised – transition where needed

Balancing huge investment needs and costs to consumers


ofgem
Promoting choice and value
for all gas and electricity customers