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Dear Jonathan,

I am responding on behalf of Citizens Advice to your open letter seeking initial views on the framework of the RIIO-2 price control. Citizens Advice is the statutory advocate of energy consumers in Great Britain. Detailed comments are offered below. In summary, we believe Ofgem should:

- Seriously consider models of consumer engagement that could provide detailed scrutiny of energy networks' business plans;
- Use greater indexation and tougher incentive benchmarks to ensure that networks earn a fair return on investment that represents good value to consumers;
- While supporting the alignment of ED1 and T1 in principle, be mindful of practical constraints on this;
- Review how the IQI and fast-tracking worked in RIIO-1, with the aim of encouraging network companies to submit more efficient costs for outputs;
- Scrutinise whether the 8-year price control length is really delivering the benefits for consumers that network companies have often argued they do.

We have structured our response according to the five themes you outline in the open letter. We welcome the open and participative approach to engagement that Ofgem has committed to so far in designing RIIO-2, particularly in seeking views through this open letter rather than moving immediately to a strategy consultation phase. We look forward to collaborating on the design of RIIO-2 in the future.

In terms of engagement regarding the RIIO-2 Framework decision making process, we welcome the commitment that Ofgem has set out thus far. One further suggestion is to establish a consumer-specific group to consider proposals from the industry working groups that are pertinent to consumers. This may be the most efficient way of ensuring that the consumer voice is heard at this stage on the most important issues.

1. Giving consumers a stronger voice in setting outputs, shaping and assessing business plans

We welcome Ofgem's intention to think more comprehensively about how the views of consumers can best be brought into the RIIO-2 framework.

Consumer engagement during the price control

Businesses in competitive markets need to respond to customer needs in order to thrive. It is important that these signals are replicated in monopoly businesses. As we progress through a profound change in the energy system it is vital that energy networks become as responsive as possible to their customers. We have already seen how the stakeholder engagement incentive has improved the responsiveness of networks during the course of RIIO-1, and encourage Ofgem to be ambition in strengthening this mechanism for RIIO-2 For engagement with consumers during the price control, we think it is appropriate that Ofgem sets out the success criteria and outcomes that will best benefit consumers, but takes a non-prescriptive approach that allows networks to adopt the methods that best suit their customer base.

We are developing our own view in this area, but at a high level we think that key features of this engagement during the price control should include:

- Direct engagement with end users consumers;
- Consideration of consumer views in development of new product/services and/or markets;

- A demonstrable commitment to embed the outputs of engagement within the business.

We are keen to work with Ofgem and industry to further develop these proposals.

Consumer input at the business planning stage

Requiring networks to engage with customer representatives during the business planning process will help to ensure that the plans deliver the best outcomes for consumers. Your letter raises a number of interesting possibilities which merit further exploration and discussion.

We believe the model of consumer engagement followed in the regulation of Scottish Water merits further attention. It appeared to have the following advantages to recommend it:

- An experienced, independent Customer Forum who were recruited both with the expectation that they would be broadly representative of consumers and that they would bring relevant expertise;
- The requirement that the Customer Forum formally sign-off Scottish Water's business plan before consideration by the regulator, requiring Scottish Water to pay due attention to the Forum's input;
- An independent research budget as well as regular briefing notes from the regulator, so the Customer Forum was well-placed to challenge and scrutinise Scottish Water's proposed outputs and costs.

It is unlikely that a model can be copied over without adjustment to the energy sector, and care would need to be taken to ensure that the needs of major grid users and suppliers are taken into account as well. However, an approach to consumer engagement that gives representation proper resourcing and influencing power strikes us as attractive, as well as perhaps providing scope to reduce the resource burden on Ofgem. Ofgem will necessarily need to be more prescriptive in regards to the design of this consumer engagement, as - given the 'one-shot' nature of designing the price control - it is not a process that network companies can iterate until they get it right (unlike their business-as-usual stakeholder engagement).

Willingness to pay

We would be supportive of a wider programme of consumer preference research, though with the caveat that careful thought will be required as to whether willingness-to-pay research is a good indicator of *genuine* willingness to pay and will need to be triangulated with other sources of evidence.

Consumers' right of appeal

As noted in Energy Consumers' Missing Billions, we believe there is currently an asymmetry between consumer and company power when it comes to reopening the price control. Network companies may apply for the disapplication of the price control in a situation where *'an efficiently managed company's allowance is not enough to enable it to finance its regulated activities.'*

It is, of course, prudent that such a mechanism exists. But consumer groups (outside of the time-bound appeal process) enjoy no equivalent ability to request Ofgem amend the price control in the case when companies are receiving clear and unnecessary windfalls.

We therefore recommend Ofgem include a symmetrical process for use by consumer groups in situations when network companies are earning rewards in excess of what is appropriate or what was anticipated at the start of the price control. In order to minimise the effects on regulatory certainty, this would include a materiality threshold and would not *oblige* Ofgem to amend the price control. Instead, it would - when certain materiality and other reasonable conditions were met - require Ofgem to give due consideration to the requested amendments and judge them on their merits.

Defining outputs

On the remaining matters in this section of your open letter, we support defining outputs in terms of outcomes & purpose rather than in terms of particular delivery solutions. However, there are complexities to committing wholesale to such definitions so we support continuing on a case-by-case basis. RIIO-2 should aim to resolve ambiguities as to how particular outputs are defined in advance of the beginning of the price control, to ensure that the problems faced in RIIO-1 on this matter are avoided. We go into our views in more detail regarding these points in our consultation response to the parallel work undertaken alongside the T1 mid-period review here.

2. Allowing regulated companies to earn returns that are fair and represent good value for consumers, properly reflecting the risks faced in these businesses, and prevailing financial market conditions

We set out our detailed views on how companies can earn fair returns that represent good value for consumers in our report Energy Consumers' Missing Billions. We recognise that Ofgem has highlighted many of the arguments within this report as issues that it is concerned with too, particularly regarding the high equity returns that network companies are earning during this price control.

At the outset of the RIIO-1 price control, Ofgem set out its intention that the best performing companies should be able to achieve a double digit return, while the worst performing earn at or less than the cost of debt. While we do not necessarily agree that it is ever necessary for low-risk monopoly businesses to achieve returns in the double digits, we believe it is important that Ofgem set out what it is seeking to achieve in this price control.

We support several aspects of the RIIO financial framework. This includes the sharing mechanism for genuine totex efficiencies, though we believe further work should be undertaken to see whether these sharing mechanisms can be adjusted to increase the consumer share without adversely compromising the incentive properties of totex.

Increasing the use of indexation

Where possible, indexation of costs should be relied on more and forecasting less. We believe that the indexation of the cost of debt needs to be revisited to make sure it is accurately tracking market prices, taking a near-term view of debt costs. We think this should be achievable without exposing consumers to unduly volatile costs. Regarding embedded debt with longer maturities, we agree that there should be some way of recognising debt that was efficiently acquired at the time that companies are now paying higher than market prices for. However, we note that companies received considerable benefits at the time of acquiring this debt, due to Ofgem consistently setting the ex ante debt allowance too high in previous price controls[1].

Indexation should also be extended to the risk-free rate, total market return and real price effects. A critical part of ensuring the legitimacy of returns is making sure that they accurately reflect market benchmarks.

While energy networks need to be financeable, investors' capital should be genuinely at risk of loss. As well as applying downward pressure to the baseline cost of capital, Ofgem should also ensure that incentives are appropriately balanced, increasing the scope for financial penalties rather than simply adding rewards to the baseline cost of capital, as they predominantly do under the current incentive structure.

Transitioning to CPI

We support the transition to CPI or - more likely - CPIH (now it has been recognised as a national statistic) for general price & asset value inflation. Using accurate inflation measures should be to consumers' benefit, though we recognise challenges for issues such as (e.g.) the lack of non-RPI linked gilt markets, which could lead to higher overall debt costs if not managed successfully. In this context, it may be appropriate to move over in a staggered fashion, as Ofwat are proposing for the water industry, though the benefits of abandoning RPI altogether strike us as potentially substantial.

[1] For example, the cost of debt for network companies was £327m lower than the Ofgem cost of debt allowance (Review of DPCR5, Ofgem).

3. Incentivising companies to drive consumer value by shaping or proactively responding to changes in how networks are used and services are delivered

We support in principle adequately financing networks to ensure efficient whole system coordination, particularly as the DSO transition gathers pace and finding sensible ways to align the design T1/ED1 price controls given their separate start times.

However, we would urge Ofgem to reflect on whether it has the resourcing in place to manage the design of four price controls at once before committing to such an approach. We have longstanding concerns regarding the asymmetry of resource between the regulator and industry and would be worried about any adjustment that exacerbated this problem.

We would also be sceptical about any solution that involved (for example) extending T1 to 2023, which did not allow any necessary downward adjustments to the cost of capital or other changes that would benefit consumers.

We support the potential for further innovation funding for efficient use of flexible services. Our starting position is to support technology-neutrality in encouraging networks to pursue the most cost effective solution. We would want to understand more regarding how specific new incentives would encourage networks to pursue cost-effective flexible solutions that they otherwise would not pursue.

4. Using the regulatory framework, or competition where appropriate, to drive innovation and efficiency

We think there may be links between how consumer engagement is implemented and the assessment of business plans. For example, an embedded, well resourced, independent Customer Forum (a la the Scottish Water model) may be well placed to conduct preliminary assessments of company business plans prior to them reaching the regulator. This might also relieve some pressure on Ofgem's resources, to focus on broader strategic questions and final scrutiny of companies' proposals.

Length of price control

There seems to be wide support among network companies for the 8-year price control length. However, the specifics of what it has enabled them to commit to that they otherwise would not have been somewhat thinner on the ground.

We perceive the major advantage of 8-year price controls as incentivising companies to commit to long-term plans, while the disadvantage is that any imperfections in the price control, such as those we have highlighted in Energy Consumers' Missing Billions, are 'priced in' for consumers and companies alike for a longer period. We think these disadvantages bring too many risks to consumers unless Ofgem is willing to adequately mitigate them, by including (for example) more uncertainty mechanisms, indexation and greater scope for re-openers. Ofgem should therefore only implement an 8-year price control if it is a) confident that the long-term business plan advantages are not achievable in a shorter price control and b) it can adequately mitigate these risks for consumers.

Information Quality Incentive (IQI)

We would support Ofgem reviewing whether the IQI has been successful in encouraging companies to produce high quality business plans. Given company performance so far in RIIO, we think it's important to explore whether the structure of the IQI put sufficient focus on ensuring efficient costs rather than producing high quality information. In particular, we note that in ED1, UKPN received a 0.5% IQI penalty, yet are still receiving the highest Return on REgulated Equity. This suggests insufficient focus was placed on encouraging companies to provide efficient plans.

While both parts of a company's business plan are important, given an average RoRE of 10% so far in the price control, it seems to us that there may be benefits in balancing the focus of the incentive more towards cost efficiency to encourage them to submit plans that deliver agreed outputs at the lowest cost possible.

Innovation

We support networks incorporating innovation into their business as usual activities where possible. Most day-to-day innovation should be driven by commercial interest: it should be one of the principal mechanisms by which network companies are earning their returns, not funding they receive over and above their ordinary revenue. This kind of innovation is one of the major casualties of setting the basic cost of capital too high and being insufficiently tough in how the incentives are set. If the overall revenue settlement were leaner, network companies would have much better incentives to innovate of their own accord as a business-as-usual activity.

However, we believe that there is a case for ring-fenced innovation funding for research that is likely to be commercially unviable on a project-by-project basis, but in aggregate is likely to lead to considerable consumer benefits. Given the severe technological uncertainty that the energy system faces and the enormous challenges that must be met, we believe there currently remains an important role for reasonably significant innovation funding for speculative investments that may or may not pay off.

5. Simplifying the price controls by focusing on items of greatest value to consumers

We are supportive of the principle of simplifying the price control. At present it is currently a formidable challenge for many organisations to grapple with the technical details of the RIIO settlements. Simplification is of great importance to ensure as wide as possible engagement with these complex mechanisms, that are funded by huge amounts of consumers' money. We look forward to engaging more on Ofgem's proposals.

We are supportive of an approach that applies Ofgem's focus to areas proportionate to their total cost to consumers. On the specific issue of fast tracking, it is unclear to us that this did deliver greater value for consumers in

ED1, though given only one company was fast-tracked it is difficult to reach very certain conclusions.

Our forthcoming research on Guaranteed Standards of Performance and how networks are achieving them contains various recommendations on how Ofgem can improve its monitoring in this area. Relevant Ofgem colleagues have reviewed these recommendations already.

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We hugely welcome Ofgem involving stakeholders this early in the design of the RIIO-2 Framework and look forward to future, collaborative discussions about the design of RIIO-2. Please do not hesitate to contact me should you have any questions about this response.

Yours sincerely,

Morgan Wild

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