

The Association of Decentralised Energy-Written Evidence (ONZ0011)

Introduction

The **Association for Decentralised Energy** is the UK's leading decentralised energy advocate, focussed on creating a more cost effective, efficient, and user-led energy system. The ADE has more than 140 members active across a range of technologies, they include both the providers and the users of energy equipment and services. Our members have particular expertise in heat networks, combined heat and power, demand side energy services including demand response and storage, and energy efficiency.

Summary

Ofgem's role in delivering net zero is already considerable and is only likely to grow. Whilst Ofgem does currently consider decarbonisation in its work and is progressing in some areas, its ability to act decisively and to translate high-level strategic aims into detailed policy delivery is too limited currently; including by some of the existing regulatory frameworks and parts of Ofgem's culture.

Questions

1. What role should Ofgem play in the transition to net zero? What changes, if any, should be made to its remit, responsibilities and resources?

As energy regulator, Ofgem will play a key role in our transition to a net zero energy system and ensuring that consumers and industry understand the respective roles they will play.

Going forward, Ofgem will also need to consider the broad spectrum of technologies that will play a role in delivering a net zero energy system and the move to a more decentralised system. For example, Ofgem is to be designated as the heat networks regulator through BEIS' Heat Networks Market Framework, and potentially also for Scottish heat networks, which will broaden Ofgem's remit significantly through regulating for decarbonisation and technical standards of heat networks as well as elements such as consumer protection and pricing. Unlike traditional gas and electricity markets, there are thousands of heat networks across the UK each with different characteristics. To regulate this sector effectively, Ofgem will need to –

- Be able to adapt its approach to very large energy companies and very small community-led or landlord-led schemes.
- Have closer links into, and knowledge of, the property sector; by which, many heat networks are owned.

- Have the resourcing and expertise to regulate in new areas; including potentially decarbonisation and technical standards.

2. How well does Ofgem balance environmental objectives against its responsibilities in relation to affordability for consumers?

Until the publication of Ofgem's Decarbonisation Action Plan in early 2020, Ofgem did not have clear objectives on climate or decarbonisation.

In assessing Ofgem's ability to balance these objectives now, it is important to distinguish the different roles Ofgem plays across energy policy.

In some cases, Ofgem's role is highly administrative and is wholly reliant on BEIS setting policy. For example, Ofgem has very little influence on energy efficiency improvements and associated consumer behaviour/awareness, acting only as administrator for schemes such as the Energy Company Obligation (ECO) and Warm Homes Discount.

In other areas, however, Ofgem has a stronger role to play. This is particularly important in the significant policy development and decision-making it holds in the regulation and incentives for the network operators, including the Electricity System Operator, in designing the overall framework for network charging and in future, possibly in guiding the strategic direction of codes and standards changes.

Finally, and as aforementioned, Ofgem's role is likely to grow in future – towards regulating heat networks and eventually possibly hydrogen. The regulatory regime being designed by BEIS to cover the heat networks market will include provision to regulate for decarbonisation as well as comprehensive detail on consumer protection and redress.

The ADE considers that in those areas where Ofgem has significant decision-making power, Ofgem is mindful of the need to protect future consumers which is part of its statutory duty and includes consideration of the carbon impact of its decisions within impact assessments. However, this consideration is often limited by several factors, some of which are appropriate and some which can be challenged.

Firstly, Ofgem is often reliant on Government policy and is hesitant about overstepping its statutory duties – for example, in providing greater revenue to renewable technologies as a proxy for subsidy support. This is appropriate but can create frustration and a sense that Ofgem is not working to progress decarbonisation.

Secondly, Ofgem often models renewable electricity capacity deployment as exogenous in its modelling by taking the rate of deployment of onshore wind, offshore wind etc. within the Future Energy Scenarios or equivalent as an input to the modelling, rather than as an output and modelling the impact on

deployment resulting from their decisions. Whilst the modelling does show revenue declines for such capacity which indicates a negative impact on decarbonisation, this means that the headline figures that Ofgem presents on the carbon impact of their decision-making are often quite artificial.

Thirdly, over the last few years, there has been a lack of strategic direction and willingness to set out a vision for the future that has contributed to a lack of focus and urgency in Ofgem's policy-making to enable a decarbonised energy system. This is clearest in the price controls and network charging reforms which do not seem to have a clear vision in mind of what is needed by the end of the 2020s and have therefore, struggled to prioritise the most impactful reforms for flexibility.

3. How well does Ofgem fulfil its obligations to consumers? Does Ofgem take consumer views into account sufficiently, particularly those of vulnerable consumers?

The ADE does not have a view on this question.

4. What implications will the transition to net zero have for the security of the UK's energy supply? How does Ofgem currently manage issues relating to security of supply?

The transition to net zero will fundamentally change how we ensure security of supply. Regardless of whether heat decarbonisation is electricity- or hydrogen-led, there will be a far greater role for flexibility to ensure second by second as well as intraday and day-ahead balancing of electricity supply and demand.

Ofgem has a very significant role to play in the development of flexibility in GB because it regulates the ESO and DNOs who are the major procurers of flexibility currently, it regulates the retail market where domestic flexibility is likely to become increasingly important and it designs the network charging framework that is also likely to provide strong signals for domestic and non-domestic flexibility.

Thus far, Ofgem has supported flexibility at a strategic level, but this has not translated into sufficient progress at a policy level. They have made good progress in requiring the DNOs to commit to procuring flexibility if it is more cost-effective than network reinforcement and beginning to develop flexibility markets at distribution. However, as stated below for question 5, this has been relatively slow. Further, their network charging reforms have failed thus far to produce significant progress in providing greater value for flexibility and have lacked a clear link between Ofgem's strategic direction and detailed policy development.

5. Is Ofgem's current system of price controls appropriate? Does it provide sufficient incentives to invest in the context of the transition to net zero?

Traditionally, the price control has been designed so that, put simply, if the network operators are able to beat a cost baseline for a given volume of reinforcement, they would earn additional revenue. Ofgem is already starting to evolve this in response to the need for greater use of flexibility markets to support a decarbonised energy system. They have very fundamentally changed the ESO's price control since its legal separation from National Grid and are pushing the Energy Network Association and the individual DNOs to embed this into their business plans for RIIO-ED2.

Whilst this is positive, there are more complex and significant decisions to be made in the next few years as to whether this model will be sustainable into the late 2020s and in particular, regarding –

- The appropriate regulatory framework for asset-light system operations at distribution. Currently, the DNOs are developing system operation functions alongside their traditional regulated asset base. The latter preserves their very strong creditworthiness and drives their appetite for risk and return on capital. As we are now finding with the ESO, removing this regulated asset base and placing the entire focus on systems operations creates a very different organisational risk profile and cost of capital. Whilst it is still too early to draw clear conclusions from the ESO's new price control, it does already suggest that if the DNOs are to continue to develop system operation functions into RIIO-ED3 (rather than it being taken on by another actor), it may require a fundamentally different price control structure.
- Whilst Ofgem has emphasised the importance of a whole system approach through RIIO-2 across the network operators and system operator, this is relatively superficial thus far. For example, it is very difficult for cost savings made by one network operator as a result of additional costs being incurred by another to be transferred even if it is the most cost-effective approach for the system as a whole (for example, a DNO using its assets to reduce reinforcement needs for NGET).
- The last price control was 8 years. Whilst this one will only be 5 years and there are several mechanisms within the price control to respond to unexpected changes in the market or in policy (including the wide-ranging net zero re-opener), there is still significant risk that the price control significantly constrains Ofgem and the network operators' ability to move quickly to invest towards net zero. This has been seen in the most recent price control where useful interventions were not understood at the time and no provision was made for them; for example, flexibility markets. As a result, Ofgem and the network operators have arguably had to rely too much on innovation funding and trials rather than moving quickly to embed it into business as usual.

6. Is the current system of governance for the UK energy market appropriate to secure the transition to zero? What improvements could be made and what role should Ofgem play?

The current system of governance is likely not appropriate for the transition to net zero.

Whilst relying on industry self-governance ensures access to very strong expertise in the detailed policy being reformed and an important route for industry to be part of developing proposals, it has several drawbacks in an energy system transitioning to thousands of actors and new business models.

This is because the current system relies upon industry resourcing intensive and often lengthy working groups to propose and develop modifications. This requires companies to have sufficient staff resource to dedicate to changes and leads to change being made incrementally. Whilst there are powers, such as Ofgem's Significant Code Review mechanism, to impose a more strategic and holistic change to codes and standards, they are relatively limited at present.

The ADE cautiously supports BEIS and Ofgem's proposals for very significant reform away from industry self-governance. However, we would note that these changes, as currently proposed, are likely to give very significant additional powers to Ofgem in providing and enforcing the strategic direction of changes to the energy system's codes and standards. This will only increase the need for Ofgem to be able to translate high-level strategy into detailed policy.

7. Are Ofgem's duties and powers appropriate and sufficiently clearly defined? Do Ofgem's objectives conflict and, if so, how should any conflicts be managed?

Thus far, Ofgem's duty to future consumers is useful in prompting a focus on decarbonisation but is somewhat vague.

8. Is Ofgem's relationship to Government and Parliament appropriate? Are there issues related to the split of responsibilities, transparency or accountability

Ofgem is and should be independent of Government and Parliament.

On a more day to day perspective, the relationship between Government and Ofgem is clearly at times difficult which can sometimes lead to attempts to shift blame on both sides.

The ADE is sympathetic to the view that the split of responsibilities would be clearer on the bigger issues that Ofgem plays a role in if BEIS were to provide a clearer, strategic view on certain issues. This is the case, for example, with volatile network charging signals. Such signals would reveal the value of flexibility and could be used by users and those acting on their behalf to optimise their heating and EV smart charging to earn revenue and support electricity

system operations. However, Ofgem is hesitant about developing this because of the impact on domestic customers and is therefore, looking at mitigating actions within the network charging framework itself. In this instance, a more reasonable division of responsibilities would be for Ofgem to create a framework that allows network charging to be volatile and then, for BEIS to support this by putting in place appropriate consumer protections.

9. How does Ofgem compare to similar bodies internationally? What lessons can be drawn from the experience of other countries or jurisdictions?

The ADE does not have a view on this question.

10. Are there any other aspects of Ofgem's work that the Committee should consider?

The ADE does not have a view on this question.

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