

## **SGN- Written evidence (ONZ0015)**

### Introduction

1. SGN welcomes the opportunity to respond to this inquiry. SGN manages the network that distributes natural and green gas to 5.9 million homes and businesses across Scotland and the south of England, providing warmth to over 14 million customers. Our strategy and long-term plan to deliver net zero focusses on the replacement of the natural gas in our network with hydrogen and other green gases, enabling the decarbonisation of heat in our Scotland and southern networks by 2045.
2. As one of GB's four gas distribution network companies we operate under Ofgem's RIIO price control framework and have just started the five-year price control period called RIIO-GD2 which will run until 2026. This is a critical period for essential testing and trialling of the use of hydrogen in the gas networks as a solution that can decarbonise heating in line with net zero.
3. We believe there can be a conflict for Ofgem's decision making between the interests of current consumers, future consumers and the delivery of net zero. This has become apparent around decisions on investment in the gas networks whilst there is uncertainty around the role that government policy sees for the gas networks to deliver net zero heat through hydrogen.
4. A lot of the funding for hydrogen projects in GD2 has been included as uncertainty and reopener mechanisms that can be triggered in response to changes in Government policy. It is key the process to release this funding is agile to ensure networks can make timely investments to deliver net zero projects.
5. We believe a critical intervention that is needed is for the UK Government to deliver on the Energy White Paper pledge to produce a Strategy and Policy Statement to guide Ofgem in its decision making.
6. Our answers to the specific questions are outlined below.

### Answers to specific questions

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

7. To enable Ofgem to fully assist in the delivery of net zero, we are supportive of the UK Government fulfilling the Energy White Paper pledge to consult on a Strategy and Policy Statement for Ofgem as soon as possible.<sup>i</sup> This was first consulted on under the coalition in August 2014 but the lack of a final statement has left a gap in terms of the priorities the regulator is to deliver on.<sup>ii</sup>
8. A lack of clear strategic direction from Government creates a risk that regulatory decisions are made with short term interests of consumers in mind that could close off potential least cost pathways to decarbonisation. They could also lead to higher overall emissions if investments that would reduce greenhouse gas emissions, such as reducing natural gas leakage rates, are deferred or cancelled on cost grounds.
9. There is an increasing requirement for Ofgem's RIIO price control regime for energy networks to determine investments depending on whether they are required to deliver net zero. Under the RIIO-GD2 price control now underway there is an increased level of net zero related funding through reopener mechanisms and uncertainty mechanisms rather than as part of the core price control settlement. These mechanisms can be triggered in response to government policy decisions down the line.
10. To ensure the price control process is not a blocker to key net zero investments, it is important that Ofgem ensures these mechanisms are agile – whilst having the appropriate checks and balances – so they can be triggered quickly in response to government policy decisions, especially around how heat is to be decarbonised. Having an appropriate process for legal review of these decisions is also important to maintaining investor confidence.
11. A critical point of debate for Ofgem and the wider transition to net zero will be the balance of risk between the investor and the customer for responding to change. The level of pre-emption of investment to facilitate a change in the energy mix will need to be weighed up against the risk of under-utilised or stranded assets. The current approach does not support pre-emptive investment in the networks in order to reduce the risk of stranded assets to customers.
12. In terms of the scope of Ofgem's role, we broadly support that Ofgem is the appropriate regulator for heat networks and carbon capture. It is important that the regulator is able to take a cross-energy spectrum perspective. But it is also important that they are able to point out to government where policy may be distorting or having an unintended consequence on other parts of the energy system.

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

13. In our experience, Ofgem tends to take a narrow perspective of environmental objectives. These are often limited to enabling the production of clean energy rather than wider environmental objectives energy network companies could deliver under price controls like increasing use of low carbon transport.
14. A central analytical tool in the price control mechanism is the use of a regression-based approach to assessing costs. This by definition looks to compare network costs on a comparable basis according to the workload that they undertake. A critical flaw in this approach is that only the workload that is recognised within the regression model will be considered. This assessment approach therefore disincentivises network companies from stretching themselves to undertake activities in areas that are not recognised within the workload mix recognised in the regression model. Secondly it disincentivises network companies from offering greater quality that incurs a higher cost rather it incentivises the maintaining of the average.
15. Ofgem need to carefully consider how networks are encouraged to stretch themselves without a risk of penalty in the price control process.

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

16. Ofgem need to decide how they want to use Consumer Engagement Research in the network price control process and be clear on the weighting it will apply towards the outputs of the research.
17. As networks we find the consumer engagement process very helpful and insightful as we develop our business plans and have conversations with our customers. However, there appears to be a lack of confidence and/or trust in the consumer evidence that is presented by network companies. As such it appears to be disregarded by Ofgem.
18. Secondly, because the costs and the outputs are put through the regression modelling approach all the insights, the justifications and all

evidence of the willingness of customers to pay for a change in approach is completely disregarded in the regression assessment..

19. As such these two attributes introduce a risk that customer engagement becomes an expensive process which unfortunately has a limited impact on the actual outcome of the price control itself.
20. We think that it is very important to have greater clarity on how consumer views that are collected by network companies when developing their business plans should be considered by Ofgem in the business plan assessment process.

**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?**

21. From a gas perspective, Ofgem's current role is to make sure the market works properly with the transmission & distribution networks responsible for transporting gas safely to customers and balancing the system, and gas shippers buying the gas from the wholesale market to meet the needs of their customers.
22. Responsibility for security of supply risks becoming increasingly fragmented going forward with the independent system operator Ofgem/BEIS are consulting on. This risks a risk of lack of clarity on accountability if there is an interruption to supply. It is very important that the clear accountability is aligned with the ability to manage that risk and that appropriate funding is made available.
23. The UK's natural gas system provides a crucial role to ensure homes and businesses receive the energy they need, even on the coldest days in winter. Across the year the gas networks transport three times more energy than the electricity networks and peak heat demands met by the gas network in winter can be as much as six times peak electricity demands. Flexible gas generation connected to our distribution network is also key to meet electricity demands on cold, dark, still winter evenings when renewables aren't available. This utilises the inherent daily and interseasonal storage provided by the gas networks and purpose-built storage facilities.
24. There is a need for a whole energy systems approach to deliver the transition to net zero and this must include the required focus on the storage required to allow a future net zero energy system to meet peaks in demand. We do not believe there is currently sufficient focus on facilitating the new forms of storage – like hydrogen – that will be

needed in a future net zero energy system regardless of the pathway pursued.

25. Security of supply/resilience in a net zero energy system is currently an unquantified cost. We believe there are more uncertainties on the electricity side that need to be addressed from a technical/cost point of view to provide an equivalent to the current 99.997% reliability on the gas side which is currently seen as crucial to meeting peak winter demand for heat.

**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?**

26. Under the eight-year RII0-GD1 price control that ended this year, we delivered industry leading levels of customer satisfaction, investment, savings for customers through innovation as well as steps along the journey to net zero by connecting enough green biomethane gas to meet the annual needs of over 250,000 homes.
27. Incentives for investment to deliver net zero under the price control framework are currently constrained by the uncertainty in terms of Government policy direction, particularly in terms of the decarbonisation of heat. This has led to a significant amount of funding to be included as uncertainty mechanisms that can be triggered following government policy decisions.
28. We are supportive of these mechanisms but it is crucial that, when triggered, they allow for the funding to be invested in a timely manner that is aligned with the challenge of delivering net zero in just 29 years.
29. The structure of reopener mechanisms for regional distribution network companies could impact customers from a cost perspective in a region for projects that have national benefits. There is a need to ensure these costs are distributed across current and future customers in a fair and equitable way.
30. We believe the strategic direction that would come from a Strategy and Policy Statement from Government would provide a clearer remit to allow Ofgem to balance the priorities of short-term costs of consumers and the costs required to deliver net zero.

**Is the current system of governance for the UK energy market appropriate to secure the Government's policy outcomes? What improvements could be made and what role should Ofgem play?**

- 31.** There is a need for clarity on the remit of Ofgem going forward given the delivery of net zero will introduce a range of governance challenges that were not apparent when Ofgem was created. This includes clarity around the remit of Ofgem and the independent system operator that Ofgem/BEIS are currently consulting on.
- 32.** The establishment of an independent system operator could take on some responsibilities around security of supply. While the policy intention is to include some gas system operator functions currently carried out by National Grid gas distribution, there is a need to ensure a gas remit is not tagged on to the remit of the electricity system operator as it is moved outside of the National Grid group. This is important to ensure that decisions deliver the best outcomes for the whole energy system.

**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?**

- 33.** We believe there is room for Ofgem's duties and powers to be more clearly defined and a Strategy and Policy Statement from BEIS would help deliver on this. A greater level of communication between Ofgem/BEIS and transparency around it would also be beneficial at the early stages of a network price control process to help with clarity on policy objectives around areas like net zero.
- 34.** We believe there can be a conflict between the interests of current consumers, future consumers and the delivery of net zero. An example of this we have been close to has been around decisions around the level of investment in the gas distribution networks during the RIIO-GD2 price control period now underway. The uncertainty around the role of hydrogen in the gas network to decarbonise heating has left Ofgem balancing the objectives of protecting customers from investments in assets that could become stranded vs potential underinvestment that could close off a potentially least cost pathway to decarbonisation.
- 35.** We believe there may be a need to introduce a specific statutory obligation for Ofgem to more fully take into account the policies and devolved UK administrations, particularly in areas where they may significantly differ from reserved UK policy. An example is the Scottish Government's target to reach net zero by 2045 – 5 years ahead of the

UK as a whole - and move 1 million homes onto low carbon heating (electric heat pumps/hydrogen) by 2030.

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

36. We think there is a need for clarity that Ofgem's role is implementing policy, not creating policy which is the responsibility of UK and devolved Governments. We have seen increasing political and media pressure on Ofgem in recent times which risks a blurring of the lines between Government and the regulator in terms of areas like energy costs.

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

37. In-house technical assessment capability could be an area to strengthen to reduce reliance on external advisors. This is an area we see becoming more and more important with net zero.

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<sup>i</sup>UK Government Energy White Paper, December 2020

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/945899/201216\\_BEIS\\_EWP\\_Command\\_Paper\\_Accessible.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/945899/201216_BEIS_EWP_Command_Paper_Accessible.pdf)

<sup>ii</sup> UK Government Consultation on Draft Strategy and Policy Statement, August 2014

<https://www.gov.uk/government/consultations/strategy-and-policy-statement>