Initial consultation on the RIIO-2 framework

Northern Powergrid's response to Ofgem's open letter dated 12 July 2017

KEY POINTS

RIIO-ED1 was the best developed of the RIIO price control settlements; for the RIIO-2 framework Ofgem can confidently build on ED1's successes but should also address its weaknesses.

- In much of the country, RIIO-ED1 is giving consumers good value, with returns justified by high service levels at modest costs.
- The **cost of equity** used a well-justified long term approach, protecting customers from risk, and giving network companies the confidence to make long term investments.
- Cost allowances are generally in line with requirements; including on the **cost of debt** where Ofgem's approach to approximating sector costs is state-of-the-art and is tracking down.
- Some adjustments are still warranted where the RIIO framework did not work well; more than anything Ofgem needs a simple, manageable framework with clear incentives.

- **The current high acquisition premia do not mean that the base cost of equity is set too high**; the high prices are a function of the present low cost of debt, expectations of future outperformance and/or resale values, and additional debt in ring-fenced holdco structures (supported by the cashflows from the first two features).
- Electricity distributors are ideally placed to deliver **benefits for customers** from a **distribution system operator role** and **to maintain overall accountability for the stability of local networks**. There *may* be a need for related outputs; but distributing electricity reliably at the lowest possible total cost will still be the core function, which RIIO is built to encourage.
- **Stakeholder engagement** worked well (and is still) but we need to be better (collectively) at demonstrating how we have acted on feedback and articulating the benefits to customers.
- RIIO-ED1's fixed **output incentive targets,** allowing companies to fund improvements, have delivered significant consumer benefits and should be retained for priority areas. In other areas Ofgem could use prescribed minimum standards (with commensurate cost allowances).
- Ofgem needs to think hard about **network output measures**; these started in DPCR5 as a cross-check to ensure delivery; but scope-creep could lead them into micro-management, undermine incentives for efficient delivery, and ultimately lead to higher bills for consumers.
- **Fast-track** can be made to work in sectors with enough ownership groups, creating a strong comparative **competition** at the price control review; but it remains unproven and **much work is needed** to address issues seen in the RIIO-1 reviews; failing this it should be scrapped.
- The **information quality incentive** (IQI) can be made to work effectively if Ofgem:
  - imposes a genuinely low-risk low return settlement on companies unwilling to challenge themselves on cost; and
  - uses the IQI in conjunction with high level total cost benchmarks that cannot be unduly influenced by individual companies, unlike the RIIO-ED1 disaggregated model.
- Genuine **proportionate treatment** is needed. Plans that miss a total cost benchmark by a wide margin should be subject to much more intensive scrutiny than those that miss by a small margin.
- The framework should encourage companies to target **low long-term costs**; meaning long-term (past and future) efficiency should be an important factor in cost assessment. This will encourage innovation, and also discourage 'short termism' where costs have hard-to-define outputs.
- **Other aspects of the regulatory framework**, such as rules distorting markets and encouraging free riders, need to be addressed so that the overall scheme of regulation works for a smart flexible energy system, not against it.

August 2017

Responses to Ofgem's consultation questions

Question 1. Do you agree with our overarching objective for RIIO-2 and how we propose to achieve it?

1. In general, yes, we agree with Ofgem's overarching objective for RIIO-2.

2. Our detailed comments on the ways Ofgem proposes to achieve it are set out response to the consultation questions on each topic in turn, set out below.

3. But to the list, we would add 'playing a key role in facilitating a smart, flexible energy system with clear roles and responsibilities'. Network companies should be given the responsibility of maintaining the stability of their networks (and any passive networks connected to them) at the same time as managing networks in such a way to maximise utility across the energy system and allow customers to access services and sell services from their own energy assets.

Question 2. How can we strengthen the consumer voice (primarily end-consumers), in the development of business plans and price control decisions?

4. In order to strengthen the consumer voice, prior to the development of RIIO-2 business plans, Ofgem and the relevant companies need to be able to:

   a. Explain to stakeholders where networks sit in the overall energy system , being clear about roles and responsibilities, including any factors that limit the influence stakeholders can have.
   b. Be better (collectively) at demonstrating how we have acted on feedback and give a clear articulation of the benefits to customers of this.
   c. Give consumers real options to choose from – so their involvement is tangible, including through how the interests of future consumers are taken into account.

5. But in doing all this, we also need to recognise that the interests of some individual customers would lead them to promote specific actions at the expense of other customers. Increasingly we feel that part of our role is to act as an advocate for our overall customer base and manage trade-offs, including helping Ofgem to develop the regulatory system where some parties are able to exploit it.

6. Ofgem should rule out some of the examples seen in other sectors, such as negotiated settlements. Suppliers lack legitimacy as representatives of consumers, because their interests are not aligned with the consumers they would be required to represent. A properly constituted and well-resourced

body with a duty to represent the interests of consumers could of course fulfil the role of negotiator. But if implemented properly this begins to look rather like an economic regulator.

7. Indeed, Ofgem's wider regulatory framework places limits on the extent to which negotiated settlements could be implemented, or the extent to which the voice of specific groups of consumers can be heard. For example, 'bespoke deals' for individual companies covering 'core' price control assumptions are in effect ruled out by the use of comparative competition during price control reviews to protect the interests of consumers generally. The participation of consumer interests needs to be in light of this wider regulatory framework, not instead of it.

8. Where these limits on hearing the direct voice of consumers are reached, network companies and Ofgem must work together to make sure the consumer voice is still properly taken into account. This might include, for example, collectively undertaking studies into:

   a. consumer willingness to pay for various aspects of service, recognising the extent to which views can change over time and between places; or

   b. the extent to which wider economic benefits should be taken into account in electricity distributor decision making around investment.

9. This form of research may seem abstract but is effective at taking into account the views and needs of end users, while reducing the risk of special interest capture, so as to meet Ofgem's primary duty.

Question 3. How should we support network companies in maintaining engagement with consumers throughout the price control period?

10. Firstly, companies are fundamentally incentivised to do this already – we make money by creating and delivering compelling value propositions for our customers and the only way we can do that is by engaging with them to understand their needs, present and future.

11. Ofgem could help by taking a hard look at the stakeholder engagement and consumer vulnerability (SECV) incentive: the current process of assessment is opaque, bureaucratic and burdensome, and unpredictable. As such it is almost impossible to create propositions to invest against on typical economic terms. Our preferred model would be a clear standard to meet to secure the bulk of the incentive but a smaller innovation mechanism which would inform the evolution of the standard – with decisions taken transparently based on a firm evaluation of the costs and benefits.

12. We have also identified that some of our stakeholders, notability local authorities and industrial customers would (at the margin) like us to take more risk in building network to facilitate economic growth rather than responding to it. At present the regulatory system limits our role in this, since

the connection charging methodology requires developers to pre-finance the assets and assume all of the risk. As noted above, a mechanism that takes into account wider economic benefits could be considered as an enhancement to current arrangements, particularly as new requirements to develop an economic and co-ordinated *energy system*, rather than electricity network, develop.

Question 4. Does this structured approach to defining outputs provide the right level of clarity around delivery?

13. Yes, the RIIO framework for outputs, focussing on primary outputs wherever possible (and using intermediate outputs or secondary deliverables specified at the highest possible level where necessary) provides the right level of clarity around delivery. As long as they are effectively set and then policed by Ofgem, outputs work effectively at encouraging the right behaviours, while at the same time the overall scheme encourages both cost and volume minimisation (i.e. total cost minimisation).

14. As external observers we note that there appears to have been a lack of clarity in relation to some of the outputs specified in the early RIIO-1 controls. RIIO-ED1 is the most advanced of the RIIO-1 controls, building on the 'prototype' framework established during DPCR5. In this respect it is helpful to note that most of the settlement is clear. But this clarity is always at risk of being lost as more complexity is introduced, and Ofgem must ensure it prevents this.

Question 5. How can the outputs framework be improved, including the introduction of additional output categories for example around efficient system operation for distribution network companies?

15. The outputs framework developed for RIIO, as it was implemented for RIIO-ED1, is well-developed.

16. This framework of fixed output incentive targets has a strong track record of both encouraging and funding improvements. It should therefore be retained for priority areas where improvements are most needed. For other areas, where previous priorities have been addressed, Ofgem could as an alternative move to prescribed minimum standards (with commensurate cost allowances).

17. The consultation is right to highlight that changing customer requirements, combined with new technologies, mean it is likely to be efficient for electricity distribution system operation to become increasingly active. The regional electricity distribution network owners are well placed to take on this role:

    a. One person needs to be responsible in each area, carrying risks from its own decisions.

b. We already have the right people and information to develop expertise.

c. Distribution networks are more diverse, complex and intricate than the transmission network, meaning that only an owner-operator can properly balance the risks of working the network hard with the benefits of doing so.

18. Efficient system operation can then be incentivised through the RIIO framework incentives to minimise the total costs of the business; including through comparative competition at the price control review.

19. Ofgem and the electricity distribution networks will need to consider whether new responsibilities and funding streams are needed – but the existing RIIO framework, perhaps with evolutionary modifications, may well be sufficient to incentivise efficient system operation and provide necessary flexibility, since it was designed partly to ensure that distribution networks had a strong incentive to minimise costs through pursuing operational solutions, rather than just investing in assets.

Question 6. Did the outputs target the right behaviours?

20. At RIIO-ED1 Ofgem generally set primary outputs which target the right behaviours, focussing on delivering things that end users will recognise and value, and giving incentives to minimise the costs of doing so. Provided these primary outputs are properly monitored by Ofgem, and effectively policed, they will deliver the right behaviours.

21. There are more question marks over the secondary deliverables implemented at RIIO-ED1; in particular the network output measures (the most prominent of the secondary deliverables). The health and criticality index, in particular, is significantly more complex that at DPCR5. This creates an additional risk to Ofgem that its regulation could degenerate into micro-management, where:

a. companies slavishly complete investments that are not yet necessary (which would not be in the interests of end users since lifetime asset costs would be higher than otherwise); and

b. potentially complete these at the expense of other investments that, whilst more necessary, do not carry the same level of incentive.

22. The complexity also creates a risk that there are more dimensions across which companies could optimise their delivery, so apparently successful delivery may be just a mirage. Similarly, compliance with complexity costs the consumer money both in terms of the network company's costs and Ofgem resourcing. Ofgem must seek to mitigate these risks and costs by thinking hard about the system it has already created, and its direction of travel.

Question 7. How can we address areas of expenditure for which a clear output is difficult to define?

23. It may not be problem that a 'clear' output is difficult to define for an area of expenditure. If the expenditure is not necessary, then this should be revealed either through company business plans, or through revealed information on actual cost levels in the past. As these benefits are revealed over time, they can then be passed onto consumers. An inputs based approach to regulation, which Ofgem suggests it will consider, would almost certainly be bad value for consumers since it would remove the incentive for companies to innovate and reduce costs, a fundamental objective of the RIIO framework.

24. Many areas of cost may have an element of discretion over timing: the expenditure may be necessary, but it may be possible to defer it for a short period. In response to this, Ofgem should seek to set cost efficiency incentives that look through timing differences and short term peaks and troughs, and promote long-term low costs to end users. To do this effectively, the approach would also need to be implemented in how Ofgem interprets cost assessment results at price controls. We describe how this would be possible in our response to question 23 (at paragraphs 83 to 87).

Question 8. Were the output targets and associated financial incentives set for RIIO-1 appropriate, reflecting what consumers value and are willing to pay for?

25. Based on our experience with RIIO-ED1, yes, they were.

26. Firstly, most of the RIIO-ED1 the output targets and associated financial incentives were challenged in an appeal to the Competition and Markets Authority by Centrica. The CMA found no error in Ofgem's approach and the output targets were not found to be wrong.

27. Secondly, where companies have outperformed the output targets, better service has been delivered to consumers than Ofgem assumed in setting the price control. Consumers have therefore enjoyed benefits to offset any cost, and in at least one case the cost was calibrated based on consumers' willingness to pay. Moreover, now the companies have achieved this level of performance, Ofgem can use the information this has revealed on the cost of delivering this level of service, and build it into the next price control, so consumers will capture the full benefits from then onwards. **This is an example of how the British approach to regulation, whether RPI-X or RIIO, has benefited consumers.**

Question 9. What changes in the RIIO framework would facilitate returns that are demonstrably good value for consumers?

28. We believe our own returns from the RIIO-ED1 price control settlement have been demonstrably good value for consumers. Of course, a range of returns is in evidence across and within sectors and each return must be considered on its merits, based on what has been delivered in exchange.

29. More generally we think that, for a well performing company, a return on equity a little above the base return on equity established for the RIIO-1 controls represents excellent value for money for consumers. This is because the base return on equity established for the RIIO-1 controls, potentially with a small amount of upside for a good performance, appears to be well aligned with:
    a. a long term assessment of returns that equity investors have tended to earn; and
    b. evidence on investor expectations from recent transactions (where, as we explain at paragraph 40 below, observed premia do not suggest the base cost of equity is wrong).

30. However, we still think that Ofgem can make changes to the RIIO-framework that will improve the likelihood that it will secure this good outcome across the board. For example Ofgem should:
    a. Avoid cost assessment like the RIIO-ED1 disaggregated models, which were prone to error and undue influence by the companies (see our reply to question 26 at paragraph 98).
    b. Make significant improvement to the fast track incentive, or else avoid using it (see our reply to question 34, at paragraphs 123 to 125).
    c. Make much stronger use of proportionate treatment (see our reply to question 31 at paragraphs 110 to 112).
    d. Strengthen the incentives in the Information Quality Incentive (see our reply to question 26).
    e. Retain fixed output incentive targets for priority areas where improvements are most needed, but move other areas to prescribed minimum standards with commensurate cost allowances (see our reply to question 5 at paragraphs 15 to 16).
    f. Reform the stakeholder engagement and consumer vulnerability incentive (see our reply to question 3 at paragraph 11)
    g. Change the direction of travel of network output measures, to avoid micro-management and remove complexity that reduces effectiveness (see our reply to question 6 at paragraph 21).

Question 10. How can we minimise the scope for forecasting errors?

31. Many of the forecasting errors Ofgem made in the RIIO-ED1 review, and we presume other RIIO-1 reviews, stemmed from the use of overly complex models, which meant that the committee of the

Gas and Electricity Markets Authority responsible for the review, and senior Ofgem officers, struggled to provide adequate oversight.

32. For example:
    a. The RIIO-ED1 disaggregated model had significant shortcomings, which:
        i) meant the initial assessment was significantly distorted, with major corrections being required at a later stage; and
        ii) created scope for companies to 'optimise' their cost submissions and influence Ofgem's benchmark, having already seen the cost models.
    b. The assessment of potential smart grids benefits was fundamentally flawed, because:
        i) there were many calculation and assumption errors hidden within it;
        ii) it was based on a fundamentally unworkable concept, since the benefits embedded in plans were hypothetical and could not be quantified with any certainty; and
        iii) it created a distorting incentive, by favouring one type of cost saving over another.

33. Real price effects have been suggested as a specific area where indexation could be used to reduce the risk of forecasting errors. However, Ofgem considered this in detail for RIIO-ED1 and chose not to adopt it. While such indexation may give the appearance of reduced forecasting errors, in reality the available measures for indexation are an imperfect proxy for the costs faced by electricity distribution network operators (DNOs). The approach would therefore introduce additional risk to the regulatory system, compared to the RIIO-ED1 approach, and this would be detrimental to consumers because it would need to be reflected in the allowed return on equity.

34. Looking more generally, to minimise the risk of forecasting errors Ofgem needs simple, transparent, models where the incentive properties can be intuitively understood, and which can be easily understood and challenged by decision makers.

Question 11. What constitutes a fair return for a regulated monopoly network company, and how can we ensure that returns remain legitimate in the eyes of stakeholders?

35. A regulated monopoly network company needs to earn a reasonable return on its capital; if it does not then this will cause long-term underinvestment in the system, which will be to the long-term detriment of end users. A key driver of independent economic regulation is also to insulate regulated companies from political risk; doing so reduces the regulated companies' risks and hence the return on capital they require, benefiting customers with lower costs.

36. When many stakeholders consider the returns earned by network companies, they may have a distorted frame of reference in considering what is reasonable. For example, they may not appreciate that the regulatory system assumes companies are geared at 65% of the regulated asset value. If a stakeholder compares the return on the regulatory equity with the returns on investments, say, in the shares of listed companies, they may not realise that these listed companies are typically geared at a lower level than network companies, which mitigates the risks faced by equity. They may also not recognise that network companies face additional residual political and regulatory risk. The share price fluctuations of energy companies in the run up to the last two general elections illustrate how political risks act to raise investors' return requirements.

37. But there are still steps Ofgem and the sector can take to improve perceptions of legitimacy of returns in the eyes of stakeholders, by:

   a. showing how well the current system has worked, highlighting its successes;

   b. quantifying the value derived by consumers from avoided costs and better service levels, all driven by the incentives for companies to beat targets that Ofgem has imposed; and

   c. putting the equity returns of the companies in context against returns that can be obtained on well-performing equity investments.

Question 12. What factors do you think are relevant for assessing and setting the cost of capital so it properly reflects the risks faced by companies?

38. In setting the cost of capital Ofgem should be conscious of the risks facing the specific company, or at least companies operating in the same sector. This is because, although there are similarities between the energy networks (in particular in how aspects of the regulatory regime operate), there are significant differences between the sectors both in terms of the operating risks the companies carry and also in certain aspects of the regulatory regime where there are differences.

39. This has real implications for how Ofgem assesses the cost of capital so it properly reflects the risks faced by companies. The directness of those implications depends on the cost of capital component being considered.

   a. On the cost of debt, for example, evidence on the cost of debt already in issuance is directly available from the debt books of the companies. This evidence on the cost of debt will be specific to the risks faced by, and corporate history of, the sector in question.

   b. There may also be some observable sector specific evidence on the appropriate level of gearing, if different sectors seem to have adopted different levels of gearing within their respective ring fences as being optimal.

c. Once we move to parameters which are not directly observable, such as the cost of equity, Ofgem's assessment is more likely to need to be based on a qualitative comparison of the sectors – for example companies operating in RIIO-ED1 bear more risk than those operating under other RIIO sectors since electricity distributors do not have the ability to force an appeal against the continuation of the current settlement within the price control period.

40. We think that the evidence clearly supports the view that the high premia on certain regulated asset values that Ofgem mentions *are not* an indication that investors are willing to accept long term yields below Ofgem's allowed return at RIIO-ED1. Other factors are more likely to be the cause, such as:

    a. manifestly softer settlements for some companies than those allowed for most electricity distributors (i.e. the ED1 settlements moved a long way to moderate the returns being achieved by investors);

    b. the current environment of exceptionally low spot rates on new debt, lower than the rate at which past (and future) investments were (and are likely to be in future) financed at; and

    c. the support that the cashflows mentioned at (a) and (b) can provide for additional gearing outside the regulatory ringfence, creating a multiplier effect.

41. It is also crucial that Ofgem takes account of the asymmetry that exists around setting the cost of capital, in the sense that much greater damage is done by too low a cost of equity than by one that is marginally too high, since the former would lead to a long term incentive to under-invest in the asset base, causing gradual damage to the integrity of the assets on which consumers depend. Of course that does not point to establishing price controls where returns are manifestly too high.

Question 13. Can we improve our methods for the indexation of the costs of debt and equity?

42. We address the two regulatory assumptions that this question relates to in turn below.

Cost of equity

43. Ofgem set a fixed cost of equity of 6.0% at RIIO-ED1, based partly on a long term assessment of the cost of equity, but moving to the bottom end of the range from that long-term assessment to reflect recent capital market conditions.

44. A long-term approach to assessing the cost of equity is appropriate for long-term investments in network assets. This has successfully protected consumers from potential short-term disruption in

capital markets, such as during the credit crisis. Investors do not need to worry about these short-term fluctuations because they will, over the long term, be able to earn their cost of capital.

45. Indeed, there is a strong argument that, at times when the risk free rate is low, equity investors apply a higher market risk premium.[1] Ofgem's own advisors at the RIIO-ED1 review found that a counter-cyclical equity risk premium is consistent with some more recent academic research.[2] Moreover, valuation practitioners also recognise that the market risk premium varies over time, with levels they currently estimate being well above levels in the early 2000s, as illustrated by the chart below.[3]

KPMG view on the implied equity risk premium for valuation practitioners

46. Any such counter-cyclical relationship would limit the sensitivity of the cost of equity to fluctuations in its individual sub-parameters. Should Ofgem consider a move to indexation of the cost of equity, it is essential that it takes this counter-cyclical relationship into account, by fixing a long-term return on equity assumption and flexing other parameters to fit this.

Cost of debt:

47. At RIIO-ED1 Ofgem established a state-of-the-art process for assessing and setting the cost of debt. Under this process, it took into account the actual established debt book of the sector, and recognised this in the calibration of an index that would on expectation approximate the cost of the sector's debt on an ongoing basis, taking into account the new issuance that the sector was expected to require.

[1] Bowman and Chay, 1999, *Market Risk Premium and Interest Rates*, provide a summary of research that has found that the market risk premium varies inversely with interest rates

[2] Smithers and Wright, 2013, for Ofgem, executive summary paragraphs 5-7

[3] KPMG, July 2017, Equity market risk premium research summary, page 7

48. This RIIO-ED1 process should be continued at RIIO-2; although there were some technical issues with the calculation that should be resolved.[4] This benchmarking should either be conducted at the level of the sector or on a more granular basis, to reflect differences in corporate history that have led to differences in the timing of debt issuance (either between sectors or between companies within a sector), but maintaining strong incentives for ongoing cost minimisation.[5]

49. We note that the approach being proposed by Ofwat at PR19 has essentially the same effect as the approach Ofgem implemented for RIIO-ED1. The differences between the two approaches are largely superficial (since the total of Ofwat's two allowances, one for embedded and one for ongoing debt, would approximate the single value calculated from the RIIO-ED1 trailing average).

Question 14. Are there specific amendments to any core aspects of financeability that we should be considering in light of performance during RIIO-1 and the change in the financial environment?

50. The long term decline in the allowed cost of debt will increasingly place stress on some of the financial ratios on which debt ratings depend. If continued, this trend could threaten the investment grade status of network company debt unless mitigating actions are taken.

51. The decision taken at RIIO-ED1 to move to longer asset lives significantly exacerbates this issue of strained credit metrics for the electricity distribution sector.[6] Our RIIO-ED1 business plan showed that the transitional arrangements put in place were just sufficient to resolve the issue in the years up until 2023, but that the problem would continue to grow during the RIIO-2 period and into the 2030s, particularly under low interest rate scenarios like the one we have actually experienced. The table below illustrates the credit metrics we forecast for the RIIO-ED1 and RIIO-ED2 period under this type of interest rate scenario.[7]

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[4] Ofgem targeted allowing slightly less than its projected cost of debt for the sector, and set its inflation assumption too high in its conversion from nominal debt to a real assumption, further under-allowing the costs of the sector.

[5] Sectors or companies that came into their current form more recently are unlikely to have older, more expensive, debt.

[6] As recognised in the evidence presented to the Competition and Markets Authority by Ofgem during the RIIO-ED1 price control appeal hearings.

[7] Northern Powergrid March 2014 RIIO-ED1 business plan, Annex 3.2 on credit metrics, section 2.2, pages 6-8

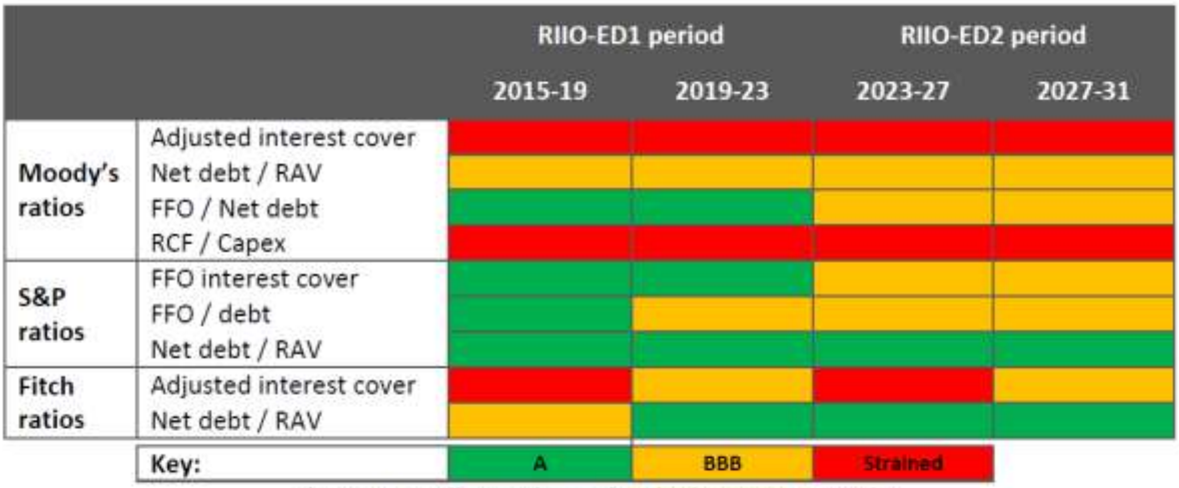

Figure 1: Credit metrics under the low rate scenario

52. There are a number of levers Ofgem could use to address this issue. These include, for example, revisiting the decision on asset lives. This policy in any case conferred a short-term benefit on consumers over the next 20-30 years, so they would pay even less compared to a cost reflective charge for the assets they are using, but came at significant expense to future consumers, so we expect the decision was a relatively finely balanced one.

53. If other financeability actions cannot solve the issue, Ofgem could reduce the assumed gearing in the price control. If it does so, it is important that Ofgem maintains its policy that it will make an allowance for the equity issuance costs that the 'notional' company would incur in making this move.[8]

Question 15. Should we consider moving to CPIH (or another inflation index) and how should we put into effect any change to ensure it is present value neutral for investors?

54. Ofgem has considered whether or not to move to an alternative price index, other than RPI, at every price control review since DPCR1, so it is not unprecedented that Ofgem would consider this again for the RIIO-2 framework.

55. The considerations are likely to be similar this time, although we note that in the past it has generally been CPI that has been considered, rather than CPIH. CPIH has the advantage of better recognising housing cost. It is not however backed by the same legal framework as CPI, and this represents a disadvantage of CPIH from the point of view of investors, relative to CPI.

[8] See RIIO-T1 and GD1 strategy decision, financial issues document, appendix 3. This mechanism would need to be run as part of the price control review if Ofgem chose to step notional gearing downward from one period to the next.

56. One of the key tests Ofgem has considered before is whether or not there is a liquid market for CPI-linked bonds, and whether the government's debt management office has decided to make the change.[9] To date these conditions have not been met, although limited amounts of CPI-linked debt has now been issued by corporate and municipal issuers.

57. Although the conditions Ofgem set previously for a move to CPI have not yet been met, the second part of the question asks how any such change could be made net present value neutral for investors. If Ofgem were to make the move, then to ensure neutrality it would need to recognise this in its calculations of three key parameters:

    a. the cost of debt;

    b. cost of equity; and

    c. real price effects.

58. Assumptions for all of these would need to be uplifted by the long term gap between CPIH and RPI, either automatically though the calculations used to derive the parameters (substituting CPIH for RPI in the calculations), or else through a specific adjustment where this is not possible. On our initial estimate, we expect the uplift would be around 0.85 percentage points. In short, current consumers would pay more for their services, but future consumers would pay less as a consequence because the RAV would grow more slowly.

Question 16. Do you think there are sufficient benefits in aligning the electricity price controls to off-set the disadvantages we have outlined?

59. It is not necessary to set price controls simultaneously for them to operate in an aligned fashion, since all the relevant architecture can be put in place at each price control in succession: and so would just come into operation at slightly different points in time for each sector.

60. Of course, they might not be perfectly aligned in the sense that the approach chosen by Ofgem at two different times, based on different information sets, might differ. A staggered approach might therefore mean the two price controls might not quite 'meet in the middle'.

61. But this does not mean that either price control would be 'wrong'. Indeed, if Ofgem set them both simultaneously it would just mean that the information available at that point in time was 'locked in' when information available at a different time might suggest a slightly different design.

[9] For example see the RIIO Handbook, at page 100, where Ofgem made a re-consideration of its use of RPI for price control indexation conditional on a market for sterling CPI index linked bonds developing.

Question 17. Are there any other realignment options we should consider?

62. One alternative would be to set RIIO-2 reviews such that, by RIIO-3, the relevant controls were aligned. This could be done in a number of ways: for example, Ofgem could set RIIO-T2 in two shorter parts (e.g. two five year parts), the sum of which add up to the length of RIIO-ED2 plus two years (e.g. ten years, assuming that RIIO-ED2 is eight years long).

63. However, there would be disadvantages from most approaches to adjusting price control length, since by definition it would mean one sector having price controls that are not the length Ofgem considers 'optimal'.

Question 18. What amendments to the RIIO framework, if any, should we consider in supporting companies to make full use of smart alternatives to traditional network investment?

64. Unprecedented change is taking place in electricity distribution, with generation decarbonisation proceeding at pace and with the country on the cusp of a revolution in electrification of transport that will significantly impact the grid.

65. However, it is important to remember that the RIIO framework was designed to support companies making full use of smart alternatives. While it may be necessary to make amendments and refinements to some aspects of the RIIO system, we would not expect this to apply to those parts of the regulatory system that were designed to facilitate the low-carbon transition, such as the role of total cost incentives (both within the period through the equalisation of cost saving incentives, and at the price control through total cost benchmarking).

Question 19. Given the uncertainty around demand for network services, how much of an issue might asset stranding be and how should this risk be dealt with?

66. We expect that any asset stranding of 'core' network assets is likely to emerge gradually over a long period of time. For example, the following scenarios could both lead to stranding:
    a. The country could move away from gas for heating purposes, and if it moves to electricity (rather than other alternatives that utilise existing gas assets, such as hydrogen) this could lead to gas assets becoming stranded.
    b. The shift of deployment of generation and storage assets from the super grid to distribution networks, and the roll-out of the internet of things, electric vehicles and other smart technology, could make it possible over time that power flow on regional and local networks

will grow faster than power flow on the super grid. Indeed as large power stations close and new large power stations continue to be deferred, it is possible that utilization of the transmission network may fall, making stranding a possibility at super grid voltages.

67. But the scale of both of these changes (in terms of network, consumer and other assets) highlight that it is unlikely stranding will occur overnight. Indeed, if a planned or evolutionary transition were to bring it about, it would likely take decades (as illustrated by the 15 year plus timescale for a much smaller transition, from decision taking to expected completion, in the smart meter roll-out).

68. Any lengthy transition would provide the opportunity for the regulatory system to scale back the extent to which any necessary work on the assets was funded over the long term through RAV, by funding new work on a cash basis. Meanwhile, companies may be able to scale back their asset investments recognising the new outlook.

69. However, this cannot mitigate all risk of stranding, and so Ofgem also needs a backstop policy to protect investor confidence. To achieve this, investments should be 'bought back' by Ofgem on behalf of energy consumers, through pass through arrangements via un-stranded energy assets. For assets built after asset stranding became a likelihood further scrutiny may be needed before they can enter the mechanism – such as up-front regulatory approval, or ex-post efficiency review.

70. By taking these steps now Ofgem may be able to maintain the low risk status of the sector which energy consumers are currently benefitting from (through the high assumed regulatory gearing).

Question 20. How do we need to adapt the RIIO framework, and the uncertainty mechanisms in particular, to deal with this uncertainty?

71. The RIIO framework itself is designed to address uncertainty, by strongly incentivising innovation to meet new requirements, and through a range of uncertainty mechanisms that allow the price control to flex in response to new developments. This gives Ofgem the necessary tools to manage uncertainty, but for RIIO-2 Ofgem needs to consider if it is making sufficient use of these tools.

72. At the RIIO-ED1 review, we promoted the use of a low-carbon technology allowance driver, so that allowances for 'additional' demands being placed on the network would be provided as and when those demands materialised.[10] This would have provided companies certainty of funding but avoided the need to predict the rate of uptake of new technologies, which is inherently uncertain. Moreover, it would have placed the onus on companies for judging when and where investment

[10] https://www.ofgem.gov.uk/sites/default/files/docs/2012/12/npg_ed1stratresponse_annex1.pdf

ahead of need was commercially justified. It would also have allowed Ofgem to set lower baseline allowances.

73. Although Ofgem choose not to implement such a mechanism in the RIIO-ED1 review, it should be considered again in light of the circumstances for the RIIO-ED2 period.

74. Moreover, similar uncertainty mechanisms might be possible in other RIIO sectors, to the extent they do not already exist.

Question 21. Is an eight-year price control period with built-in uncertainty mechanisms still appropriate given the greater range of plausible future scenarios?

75. When RIIO was established, Ofgem was already cognisant of a wide range of plausible future scenarios. While some new scenarios have come into focus, others have faded, and it is not clear that the range is necessarily greater now than when RIIO was established.

76. The eight-year control, with uncertainty mechanisms, was chosen to maintain strong incentives to innovate and find ways to minimise total costs, while allowing sufficient flexibility. It is not clear that anything has changed to support a different approach, although Ofgem could make changes within this framework (e.g. implementing some uncertainty mechanisms it chose not to use at RIIO-1, such as a low carbon technology volume driver for electricity distribution, described in our response to question 20).

Question 22. What improvements should be made to the assessment of business plans?

77. In the business plan assessment at RIIO-ED1, in the end very little mattered other than the assessment of costs.

78. In some respects, this was partly a consequence of Ofgem setting the binding output targets for the companies. For example, Ofgem's primary outputs framework means that consumers were assured of delivery of a certain target level of performance or price reductions if this performance was not met. The business plans were therefore dominated by the costing of this level of delivery, rather than the costs of proposing a bespoke deal which would be more difficult for Ofgem to assess.

79. But while bespoke deals should be avoided (wherever possible), and Ofgem should put in place an appropriate set of outputs, Ofgem should also take into account the quality of the plans. In particular, it should consider the strategies and decision making frameworks being actively employed by the business in assessing credibility of whether the plan will be delivered, and the value for money of what will be delivered. Preparation of business plans of the type required for RIIO to

operate takes a significant amount of effort, and imposes associated costs, and Ofgem should ensure that its routines are designed to ensure this additional rich source of information is properly taken into account in its assessment. If plans are treated as a necessary hygiene factor that show only that a company has communicated with its stakeholders then this would create limited incentives for companies to use them to demonstrate that they have in place effective approaches to managing the business.

80. Lastly, the cost assessment must be made significantly more robust than the disaggregated models at RIIO-ED1, in conjunction with genuine proportionate treatment and an improved information quality incentive. We set out further details in our response to question 26.

Question 23. Should we give further consideration to companies' historic performance against their business plans?

81. Ofgem should give more consideration to historical performance generally. At RIIO-ED1 there appeared to be very limited role for this in assessing the plans, especially in the slow-track assessment process where little mattered other than the costs companies were promising to deliver in the next period.

82. Taking into account historical performance is an important part of the RIIO framework.[11] However, Ofgem must be careful how it gives this effect. In particular, Ofgem should not expect companies to have delivered exactly the plan they set out. Any company that did would almost certainly have delivered the wrong things, because over an eight year period new information will come to light, and companies should respond to this. Moreover, as well as this practical point, there are regulatory reasons why Ofgem must not focus too much on whether the list of items in a plan was delivered:
    a. Ofgem did not allow the business plans of most companies; instead it substituted its own view of appropriate costs and volumes; for these companies many commitments went unfunded, and comparisons with better-funded companies would be wrong.
    b. Placing undue weight on whether companies have spent according to their business plans would damage incentives for companies to reduce costs to customers where possible.

83. When assessing performance against plan, Ofgem should therefore assess whether the company shows evidence of having developed a credible plan for RIIO-1, that set a good framework and was well executed, making improvements for its customers where justified, and generally demonstrating effective asset stewardship that is designed to minimise costs to consumers.

[11] Ofgem, 2010, RIIO Handbook, pages 59-60, paras 8.15 to 8.21

84. On the level of costs incurred more specifically, Ofgem should design its assessment of historical performance to encourage companies to deliver long-term good value for consumers. It can do this by assessing whether companies are delivering comparatively low costs to consumers over a sustained period. There are two measures which would be relevant to this assessment:

   a. the efficiency of costs proposed in the forthcoming period, relative to an appropriate total cost benchmark, as a measure of the value for money for consumers of the next regulatory period; and

   b. the value for money of what was delivered in the regulatory period that is drawing to a close, measured based on the *costs to consumers* delivered by the company (i.e. allowances adjusted for the sharing factor) relative to an appropriate total cost benchmark.

85. By taking into account these two measures, Ofgem would gain an insight into whether a company was offering *long-term value for money,* and encourage this approach through its price control settlements. A company might for a period need to invest at a high level, but this could still offer good value if it has charged lower costs to consumers in previous periods than other companies (and vice versa). This would not necessarily be any better or worse than a strategy that involved maintaining costs at a stable level over the long term. Companies falling in each of these three scenarios would validly be subject to a different hurdle in Ofgem's assessment of its plan for the forthcoming period, because each would have a different history of costs in the previous period.

86. Moreover, such an assessment would limit the undue value companies could gain from any form of asymmetric information.[12] While short-term returns could still result from asymmetry, the regulatory framework would actively recognise that it was value for money to consumers that mattered, and so the company would need to offer better value in the next price control round or otherwise expect intense scrutiny from Ofgem over the extent to which costs it was proposing in its new plan had in fact already been funded in the previous price control period. It would also help limit the risk that companies setting an uneven profile of costs over time lead to inappropriate benchmarks being imposed on other companies in specific regulatory periods – because Ofgem could actively recognise that costs in the forthcoming period are not all that matter to the cost of delivering network services.

87. It is important that nothing Ofgem does in how it treats historical costs discourages companies from legitimate cost saving. This approach would in fact strengthen incentives to legitimately save costs,

[12] Whether the active kind, or the passive kind where they simply fail to challenge their own planned cost base properly before submitting it to Ofgem

where this does not increase future costs. Not only would a company saving costs in the current period enjoy benefits under the sharing factor, but to the extent some of the savings are passed on to its consumers, it would also offer those consumers better value. This better value would give it some 'credit' under the historical part of the mechanism. But the approach would weaken current incentives for short-term cost saving (which must be caught-up in the next period), because a company may gain under the sharing factor, but would not be able to use its consequently higher investment needs in the next period as an adequate justification for more allowances in that period.

Question 24. Should we determine the revenues an "efficient" network company requires before seeking information from the companies themselves?

88. If Ofgem were to take this approach, there is a risk it would undermine the competition for information that the RIIO framework is designed to elicit through business plan submission, the IQI and (potentially) fast-tracking. Put simply, if Ofgem has determined the efficient revenues already, companies may choose to go no further than this. Alternatively, if Ofgem's assessment is too low because it has not taken into account relevant factors, Ofgem will find it hard to soften its position in light of stakeholder criticism. Neither outcome would be good for consumers.

89. However, if notwithstanding these objections, Ofgem chooses to go down this route, it would be important to avoid using any cost assessment models that could allow companies to 'optimise' their business plans and improve their efficiency score without reducing their costs. A simple total cost benchmarking approach, with cost drivers that are entirely beyond the control of the relevant companies, would prevent this. It would be vital that Ofgem avoid cost assessment like the RIIO-ED1 disaggregated models.

Question 25. What has an eight-year price control period allowed network companies to accomplish or plan for that would not have occurred under a shorter price control period?

90. Longer price controls strengthen regulatory incentives to enhance outputs and reduce costs since benefits are retained for longer.

91. For example:
    a. A company can now retain benefits from an innovation that increases reliability for up to eight years, not up to five as was previously the case, increasing the rewards for innovation.
    b. Companies must now wait longer for the next cost reset, placing the onus on them to manage their cost base, including through innovation, in face of new customer demands.

c. The fact the onus is on companies to manage their business for longer, without an option to force a reset (as is the case in the RIIO-ED1 control), encourages a culture of cost control and innovation, which it would be difficult to sustain to the same extent under shorter periods.

92. In very practical terms, companies are now able to plan to tackle longer-term improvements that were previously more challenging to undertake in the five-year cycle, because the price control reset would create a break point mid-way through the project with all the associated uncertainty, potential discontinuity of the framework, and necessary distraction of time for key individuals that may also be involved in those improvement projects.

93. The stronger incentives associated with a longer control period have also had a particularly beneficial effect in areas such as customer service where performance was already quite high, and incremental improvements become increasingly marginal. A longer price control period has created an environment that encourages companies to pursue such gains.

Question 26. How well has the IQI and efficiency incentive worked in revealing efficient costs through the business plan process and encouraging efficiency throughout the price control period?

94. The information quality incentive (IQI) was undermined in the RIIO-ED1 review by weaknesses in the cost assessment process, and a lack of serious distinction between those companies that challenged themselves on cost and those that did not.

95. However, it can be made to work effectively if Ofgem:
    a. imposes a genuinely low-risk / low-return settlement on companies unwilling to challenge themselves on cost; and
    b. uses the IQI in conjunction with high level total cost benchmarks that cannot be unduly influenced by individual companies, unlike the RIIO-ED1 disaggregated model.

96. Effective and robust cost assessment, where the results for a particular company cannot be easily distorted by that company or through 'hidden' modelling choices, is vital for the current 'finely designed' IQI to work. If this robustness breaks down, and the company can influence its own cost assessment results through the form of its plan, then the IQI fails to provide a strong enough incentive to submit challenging plans. The company could do better by submitting a less challenging plan. Using technical language, the current IQI is only 'incentive-compatible' when used in conjunction with robust cost benchmarking.

97. Even then, it provides fairly weak incentives except at the extremes. Robust cost assessment can therefore be buttressed through an IQI which imposes a genuinely low-risk / low-return settlement on companies unwilling to challenge themselves on their costs forecasts.

98. Speaking based on lessons from the RIIO-ED1 review:

   a. The disaggregated assessment was not robust. The highly complex models, which frequently used high costs in one category to justify high costs in another, and failed to make any assessment of the efficient volume of interventions in other places, could be 'optimised' against by a company that chose to do so. This was particularly the case once Ofgem allowed companies to resubmit their business plans having seen the model.

   b. Even the RIIO-ED1 top-down totex model used a cost driver which was to some extent under the control of the relevant companies, i.e. modern equivalent asset value; these models could be easily improved through the use of customer numbers as a genuinely exogenous cost driver.

   c. The IQI itself, built on formulae that vary for any potential cost benchmarking result, was too fine-tuned and therefore too constrained to impose a genuinely low-risk / low-return settlement on companies that did not challenge themselves on cost. A shorter menu of categories for companies to fall into, with bigger differences between them, would provide Ofgem with a mechanism that allows for greater differentiation.

Question 27. What alternative approaches could we consider to encourage companies to give us high quality information that minimises the damage from their information advantage?

99. Ofgem already has a wealth of tools available to it to minimise the impact from any information advantage held by companies. These include total cost benchmarking based on exogenous cost drivers, other key aspects of the RIIO framework such as the competition Ofgem sets up at price control reviews for companies to submit challenging cost forecasts, and the information quality incentive (subject to our comments on this incentive in response to question 26, above).

100. When assessing this issue, it is worth noting that companies beating certain targets is not evidence of asymmetry; it is more likely that the discoveries that allowed this came later, and were in fact a product of the strong incentives Ofgem establishes through its price controls. Without these strong incentives, the same improvements might never have been identified.

101. Ofgem may also currently suffer from information overload, rather than too little information. If this is the case, then the solution lies in establishing simple, easily understood, and robust assessment

techniques, focussing on the most important issues in order to establish clear incentives. The challenge to Ofgem comes in asking for the right information, and undertaking the right analysis of the information it does receive.

Question 28. What impact has the innovation stimulus had on driving innovation and changing the innovation culture?

102. We are deploying innovation in the ED1 period having learned from our own and others' innovation.

103. Not only has the innovation stimulus directly driven innovation via the projects it funds, but it has also helped focus the innovation culture that had already been fostered through years of strong incentives to reduce costs. This culture of using innovation to reduce costs has been demonstrated through initiatives we have implemented outside the innovation funding framework, such as:

   a. The use of active network management to facilitate lower cost connections, for example distributed generation connecting in areas that would otherwise be constrained. We already deployed this in the DPCR5 period to significant customer benefit, and are continuing to deploy it in the RIIO-ED1 period to deliver major savings for connectees.

   b. The use of bespoke voltages where this solves problems that would otherwise arise on the network. We already used this during the DPCR5 period to avoid the need for some reinforcement. We are now rolling a similar principle out across a much wider network area, particularly where it helps create capacity for low-carbon technologies to be deployed in residential areas.

   c. Our entire operational IT and telecoms programme for the RIIO-ED1 period was designed around facilitating smart network management in the future, at little or no additional cost beyond that which other companies justified using traditional solutions.

Question 29. Have the incentives inherent in the RIIO model encouraged network companies to be more innovative and what should we consider further?

104. As set out in response to question 28, the incentives inherent in the RIIO model have encouraged network companies to be more innovative.

105. Beyond this, Ofgem and the Department of Business, Energy and Industrial Strategy (BEIS) need to consider what role they want DNOs to play in the wider energy system. Some of the regulatory limitations currently imposed on or being proposed for DNOs will actively hinder innovation and limit the ability of distributors to actively control their networks (for example proposed restrictions on whether DNOs are able to operate batteries).

106. Similarly Ofgem and BEIS are allowing a number of regulatory distortions to persist that make no economic sense and hinder innovation, such as the ability of independent distribution network operators to undercut established DNOs on the basis of nothing other than a less restrictive connection charging methodology. Not only are the value flows opaque, through payments to property developers rather than lower energy bills, but the system is being further fragmented in such a way that will make it more difficult in future to realise benefits from active network management. Such systems may have made more sense when this approach to regulation was put in place but the pace of the energy transition means that the world has changed.

Question 30. ***Do you agree that the scope of competition should be expanded in RIIO-2? What further role can competition play?***

107. Ofgem should work hard to ensure an effective competition to reveal information through business plan submission, within those sectors where it judges that this can be effective.

108. We note that Ofgem had plans to introduce additional competition in major onshore transmission projects. While the legislation for its preferred option may be delayed, Ofgem could consider whether there are other routes to increase such competition.

109. Critically Ofgem should not confuse diversity of operating models with effective competition. In energy systems this diversity tends to arise from certain parties exploiting regulatory loopholes to avoid costs that policy makers have decided it is appropriate for energy consumers to bear. This loads those costs ever more heavily on existing consumers, is manifestly unfair, and the resulting distortions create economic inefficiency.

Question 31. ***Which elements add the most complexity and how do you think that these and the broader RIIO framework could be simplified?***

110. Ofgem's use of disaggregated cost assessment to assess sector wide costs at the RIIO-ED1 review was one of the most complex pieces of regulatory calculation we have ever seen. The modelling:

   a. set entirely the wrong incentives in many places;
   b. failed to scrutinise aspects of plans that should have been challenged (such as the volume of interventions planned in particular areas); and
   c. was prone to serious error as evidenced by the large change in results between the fast track and slow track models.

111. These 'cookie cutter' models were manifestly not up to the task required by proportionate treatment under the RIIO model; since they were 'one size fits all' and not designed to apply scrutiny intelligently to those companies and areas of cost most in need of it.

112. Ofgem should not attempt to build these types of highly complex model at the RIIO-2 review. Instead, a simple approach to proportionate treatment should be used, where companies can be ranked based on a simple total cost assessment, and allocated into a number of distinct categories of treatment, with varying levels of more detailed scrutiny applied to plans that perform poorly – where this scrutiny is tailored to the obvious problem areas of the relevant plans. Lastly, as we highlight in paragraph 97 in response to question 26, a genuinely low-risk / low-return settlement could be imposed on those companies in the categories requiring the most scrutiny.

113. We also highlight in our response to question 6 that the growing complexity of network outputs measures represents a key risk to Ofgem's regulatory system.

Question 32. What improvements could be made to the format and presentation of the business plans?

114. At RIIO-1, Ofgem let companies determine the presentation of business plans. This allowed:

   a. many ideas to be trialled; and
   b. a great deal of learning about what worked best.

115. If Ofgem sets a template for the business plan format at RIIO-2, this innovation and learning will stop, and little more will be learned in terms of how to effectively present and communicate this type of business plan. So in terms of the plans themselves, companies should each individually seek to identify what improvements should be made to the format and presentation based on all the learning available to them.

116. A subset of stakeholders require information across all companies in an easily comparable format. Ofgem, the relevant companies and these stakeholders should work together to improve the business plan 'one pagers' of the kind specified by Ofgem at RIIO-ED1, and develop these further in a direction that would be most useful to these stakeholders.

Question 33. Should the plans be revised at any stage during the price control, for example annually?

117. In general, no. Plans should be written to last for the period and shouldn't change from year-to-year.

118. Of course, this doesn't mean that companies should be slavishly required to stick to exact deliverables, which would create inefficiency. Instead, it means that the plans need to be written to be flexible, for example to different evolutions of local spatial requirements.

119. The existing reporting routines, including reporting on delivery of the business plans, can be used intelligently to highlight any adjustments without imposing any additional administrative costs that would ultimately be borne by consumers.

Question 34. Should we retain fast tracking and if so, for which sectors?

120. It may be possible to make fast-tracking work in sectors with a large enough number of sufficiently comparable ownership groups for there to be a meaningful competition in business plan submission.

121. The table below shows the number of companies in each energy network sector, and a pseudo Herfindahl-Hirschman Index (HHI), using RAV as a proxy for the 'market share' of each company in the comparative competition Ofgem establishes at the price control review.

Sector	Ownership groups	Pseudo-HHI[13]
Gas transmission	1	10,000
Electricity transmission	3	6,114
Gas distribution	3	3,712
Electricity distribution	6	2,034

Table 1: relative concentration in the energy network sectors

122. It is fairly obvious that competition at the gas transmission price control review is least likely to be successful, in light of its pseudo-HHI of 10,000 (i.e. single incumbent). Meanwhile, electricity distribution is the least concentrated and therefore has the most scope for competition at the price control review, with a pseudo-HHI around half that of the next most competitive sector (gas distribution).

123. However, the 'winner takes all' format of the RIIO-ED1 incentive, and its inability to cater for the significant over-funding of the fast tracked company that was eventually revealed, has seriously

[13] Pseudo-HHI calculated using 'market shares' of RIIO-1 period closing RAV from the latest financial models at mid-August 2017

undermined its operation. Indeed, Ofgem chose one of a limited number of specifications in its RIIO-ED1 models that could have delivered the resulting fast-tracking decision, and even then Ofgem further chose to depart from its own rules (that said companies could not change their plans following submission) in order to confirm the result.

124. The decisions to fast-track and to not fast-track were very difficult for any party to appeal; in the first case because the relevant information did not become available until a later stage of the review, and in the second case because no route was provided for companies to challenge decisions not to conclude their price control early. Moreover, the regulatory system currently lacks an adequate way of dealing with one company having been funded to a higher level than the rest of the sector, which is a risk associated with fast-tracking that has already materialised. Ofgem's only response to date has been to create incentives, through comments in the slow-track final determinations, for the over-funded company to spend their windfall. It is this expenditure itself that creates an ongoing comparability problem, not only in cost assessment but also in the assessment of appropriate output targets.

125. If Ofgem is to retain the fast-track incentive for any sectors, it must address these weaknesses to restore the credibility of the incentive. Unless the participants believe the system has a genuine prospect of being operated in a fair manner then it will impose fairly weak incentives.

Question 35. Do we collect the right information in the right format and are there better ways to monitor the performance of companies?

126. Looking at RIIO-ED1, examples of requirements that we currently report under are:

a. annual regulatory reporting pack (RRP) templates;
b. strategic overview report (currently being trialled);
c. standard licence condition 50 report;
d. RIIO accounts (replacing regulatory accounts);
e. environment and innovation report;
f. losses discretionary reward submission;
g. stakeholder engagement and consumer vulnerability award submission; and
h. connections competition reporting under charge restriction condition 2K.

127. This should be rationalised wherever possible. By doing so, Ofgem will minimise the reporting administrative cost burden that will (over the long term) fall on consumers, and reduce the risk that Ofgem suffers information overload that prevents it from seeing relevant patterns in the data.

Question 36. What are your views on how the changing role of the electricity SO should be factored into the RIIO framework, including whether or not the electricity SO should have a separate price control?

128. The electricity system operator role is developing in multiple directions.

    a. At the distribution level, it makes sense for the existing distribution network owners to undertake the system operation role.
    b. At the transmission level, National Grid already has a transmission system operator arm.

129. In each case, it makes sense for a single organisation to own and operate the assets, since this ensures accountability is clear.

130. The RIIO framework was designed to allow strong incentives for companies to minimise the cost of running their network, while meeting the needs of network users. If the transmission system operator's costs and responsibilities are clearly enough delineated from transmission network owners, then a separate system operator price control may make sense.

131. But whether or not the electricity SO has its own separate price control, it is important that the RIIO framework's incentives for total costs are not undermined. If the electricity SO does have its own price control, this must therefore be set in such a way as not to damage these properties of RIIO.

Question 37. Do you agree with our broad stakeholder engagement approach

132. We agree that it is sensible to use the methods of engagement listed in the letter (consultations, workshops, webinars, working groups and bilateral meetings).

133. We also agree that group meetings should be open to wider stakeholders who can make a contribution to the debate.

134. We note that the open letter does not mention some of the stakeholder engagement routes listed in the RIIO handbook, such as market research (where relevant) and the price control review forum. We presume that Ofgem will use these forms of stakeholder engagement where appropriate. We discuss the role of market and other research in allowing end user views to be taken into account more fully in our response to question 2.