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Cc GEMA Board

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Dear Jonathan,

Response to Ofgem's RIIO2 Draft Determination for National Grid Gas Transmission

National Grid Gas Transmission (NGGT) has serious concerns with Ofgem's RIIO-2 Draft Determinations (DD) and its consequences for Great Britain. Whilst we share Ofgem's stated objectives for RIIO-2, the DD currently fails to meet the needs of our customers and stakeholders and is not in the interests of current and future consumers, because it:

1. **Introduces significant risk to the reliability and resilience of the network,**
2. **Creates unnecessary complexity and volatility in the framework, and**
3. **Erodes regulatory stability and investor confidence.**

We welcome the fact that Ofgem has clearly signalled this as a consultation in which it is open to making changes based on stakeholder views and through consideration of evidence. This is positive and important because we consider that a significant number of the proposals and overall package are currently unacceptable and numerous remedies are necessary for Final Determinations to address serious issues identified. We have therefore provided an evidence-based response, supplying new evidence where relevant and proposing remedies to the issues identified which better meet the interests of consumers.

1. Introducing significant risk to the reliability and resilience of our network

Our business plan, based on stakeholder feedback, proposed investment required to maintain the levels of reliability and resilience on the network. We described this using Ofgem's Network Asset Risk Metric (NARM) and set our investment proposals to maintain risk on the network and therefore maintain the current levels of reliability and resilience for stakeholders and consumer.

The Ofgem proposed reduction in baseline asset health investment will not allow us to maintain the level of risk on the network and will see the level deteriorate by 19% over the next 10 years. This is a conservative estimate of the risk impact as this is based only on assets covered by the NARM methodology and the risk could be far greater if non-lead assets[1] and major project investments in our plan remain underfunded over the RIIO-2 period. For example, Ofgem has rejected a pipeline resilience project near Greater Manchester which could increase the likelihood of loss of supply.

We have provided a significant amount of data to back up the current asset health issues and the likely deterioration we will see over the next five years. We have provided additional evidence within our DD response, which further supports the inclusion of this workload to remedy the potential impact on reliability for Final Determinations.

Remedy needed: increase asset health volumes and associated output commitments to maintain network risk.

2. Unnecessary complexity and volatility introduced in the framework

Within our business plan, we proposed a robust package of uncertainty mechanisms to protect consumers from less certain costs or to ensure that where needs change then so do our allowances. However, in the DD, Ofgem has far extended the proposed use of uncertainty mechanisms. While some of these serve a sensible function, many introduce an unnecessary level of regulatory burden, complexity and uncertainty on us and our stakeholders.

Our response provides evidence to demonstrate that efficient costs can be set for the vast majority of the investment that Ofgem has agreed is needed. For other reopener uncertainty mechanisms deployed by Ofgem, our response provides evidence that upfront ex-ante allowances for pre-construction and development costs can be set efficiently. This approach avoids regulatory burden; gives networks certainty of funding ensuring we can build and retain the right skills over the long-term; provides simpler reopener design; and avoids passing unnecessary risk to consumers.

Our customers have told us that stability of charges is vital for them in running their businesses. The uncertainty mechanisms, and financing proposals for them, introduce significant unnecessary variation in the charges for our customers with revenue only received after Ofgem decisions on the associated reopeners. Based on current predictions, customers would face a 40% increase in charges in the last year of the price control and our credit metrics would deteriorate to sub-investment grade.

We have provided financial analysis as part of our response to show these impacts on customers and our finances and have provided options to Ofgem to remedy the issues.

In addition, we have a portfolio of projects requiring approximately £69m of funds, to allow us to accelerate the transition to hydrogen and deliver Net Zero at pace for which there is no adequate route for funding. These projects do not meet the criteria, outlined in DD, for the Net Zero reopener or the Strategic Innovation Fund (SIF). This leaves the only funding route being through the Network Innovation Allowance, where Ofgem have reduced our business plan request from £30m to £20m, which significantly falls short of the funding required to be hydrogen ready. Developing and transitioning to hydrogen is not a business as usual activity, therefore funding needs to be made available. For example, our FutureGrid project, which sets

[1] Refers to assets such as pipe supports, electrical systems, and fencing

out a number of phases to test and trial the ability to transport hydrogen across our existing assets, would not be eligible for funding under current SIF and Net Zero reopener proposals.

Remedies needed:

- Provide ex-ante allowances for pre-construction works based on our evidence of efficient costs
- Deploy a volume driver mechanism where costs have already been assessed as high confidence by Ofgem
- Provide baseline allowances for uncertainty mechanisms and more closely match expected spend and revenue through forecasting of outputs
- Allow NGGT to trigger Net Zero reopener uncertainty mechanism to facilitate hydrogen developments
- Increase the Network Innovation Allowance to £75m to bridge the gap between Net Zero and Strategic Innovation Funding mechanisms

3. Eroding regulatory stability and investor confidence

A stable regulatory regime has been the reassuring anchor for investors to provide low cost financing over the last thirty years and has underpinned financial resilience through the uncertainty of Covid-19. But the DD risks this stability and will in turn erode investor confidence by proposing movements away from regulatory precedent, increasing use of ex-post adjustments and applying disproportionate, unjustified penalties.

The UK needs a progressive regulatory framework that encourages investment into the energy sector but the message to investors from the DD will be to invest overseas or in the UK water rather than energy sector. The proposed allowed equity return is below that of the water sector and most comparable international benchmarks, owing primarily to errors in setting relative risk to the market (beta) and total market return parameters and the inclusion of a flawed outperformance wedge.

There is a marked weakening of financial resilience leaving the notional company on the cusp of being downgraded from Ofgem's target credit rating and which drops below investment grade once cashflow delays are factored in.

More worryingly, with the application of disproportionate and unjustified Business Plan Incentive (BPI) penalties, efficiency cuts and outperformance wedge, Ofgem has proposed an overall package that would result in equity returns of less than 3%[2] even if we deliver the DD future productivity assumptions which are more than twice the productivity level of the general economy.

As an example, the punitive and unjustified business plan incentive penalty of £26.4m arising from a methodology which is highly subjective, manifestly disadvantages the Transmission sector and penalises for the same perceived failing multiple times. The penalty comprises an element for failing to meet minimum requirements despite Ofgem demonstrably applying a higher test than its stated 'minimum requirements' and not taking account of the views of our Independent Stakeholder User Group, despite this being a requirement of the process.

[2] Breakdown shown in NGGT Executive Summary - Figure 4: 25% totex savings required to close starting RoRE gap of 150bps

With minimal potential upside from incentives and totex performance, the framework offers unprecedentedly low opportunity to close the gap despite the need for innovation to deliver the energy transition.

Remedies needed:

- Develop a more balanced appraisal of allowed equity return and remove the flawed outperformance wedge
- Adjust the overall risk and reward package to provide a fair return for investors, dropping the BPI penalty and addressing issues with efficiency methodologies

Conclusion

Since publication of DDs we welcome the constructive dialogue we are having with Ofgem on these issues and urge Ofgem to consider the evidence presented in our response, which supports our proposed remedies, for Final Determinations. The impact of these remedies will not have material impacts on the household bill but a revised package will deliver a reliable network service, enable the green transition to net zero and provide a fair return for investors. To support our response, we have commissioned an independent expert organisation (also used by Ofgem) to test consumer preferences in light of current economic circumstances. The results of this research are included within our response and clearly and consistently show consumers' preference for investment in reliability and net zero above short term bill reductions across the various demographic groupings.

We hope you find our response and supporting documentation helpful and look forward to our continued engagement in the coming weeks, including at the open meetings in October, as we work towards a final determination which enables us to deliver for our customers, stakeholders and current and future consumers.

Regards,

Nicola

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