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GIIA Ofgem RIIO-2 Draft Determinations Consultation Submission

Global Infrastructure Investor Association (GIIA) is the membership body for the world's leading institutional investors in infrastructure. Our members operate in 55 countries across 6 continents and are responsible for over US$780bn of assets under management globally, with over a third of that value invested in the UK. In addition to investments in UK airports, ports, digital and energy assets, GIIA member assets contribute to 24% of total UK MW wind energy capacity and GIIA members are responsible for managing a network of more than 80,000 miles of pipes and providing gas services to over 14 million people across the UK.

In relation to the Ofgem RIIO-2 Draft Determinations published 9th July 2020, we are keen to provide the perspective of institutional investors in UK energy infrastructure. This submission therefore acts as a high-level position statement on behalf of the institutional investor community on the issues raised in the consultation document and associated questions. It is intended to be a constructive contribution to the difficult challenge faced by Ofgem in balancing sometimes competing and conflicting agendas in a period of significant uncertainty.

1. Section one: principles of effective regulation

1.1 Evidence-based decision making

GIIA understands and supports the need to strike the right balance between the sometimes competing interests of short-term affordability for the consumer, the need for longer term investment to address resilience and climate change challenges, as well as the legitimate expectation of fair returns for investors. However, it is GIIA's belief that the optimum balance has not been struck in the RIIO-2 Draft Determinations, which have placed too great an emphasis on short term affordability to the detriment of longer-term sustainable investment objectives whilst undermining the ability of energy companies to deliver the performance improvements and investments their customers have signalled they wish to see.

Within RIIO-2 period Business Plans, the energy network companies proposed what was thought to be a fair deal for customers, the industry and for advancing the UK's strategic energy interests by laying out plans to increase service standards, protect fuel poor customers and provide the significant investment required to transition the UK economy to Net Zero, whilst continuing to maintain high safety standards. In developing these Business Plans, companies undertook extensive stakeholder engagement exercises across the UK, details of which are provided in the next section of this submission.

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1.2 Consumer interest

Ofgem's Strategy is clear in terms of its role and remit to protect the interests of consumers in stating that Ofgem 'works to promote value for money, security of supply and sustainability for present and future generations'[1]. It is not clear, however, to GIIA and our member companies how the RIIO-2 Draft Determinations take account of the many proposals made in response to network companies' extensive customer consultation exercises, some of which were recognised as being highly consultative, including by independent third parties such as Citizens Advice.

Summary of network companies' stakeholder engagement activities:

- Cadent's 2021-26 Business Plan was developed following over 1 million interactions with customers and stakeholders and 20,000 customer engagements through more than 100 engagement events[2].
- SSE undertook 30,000 engagements, hosted 20 roadshow events and delivered 19 consultations in the development of its two-year RIIO-T2 Business Plan[3].
- SGN collected the views of more than 12,500 stakeholders, customers and customer representatives through workshops, panels, roundtables research, focus groups and face to face meetings[4].
- National Grid delivered its largest ever business plan stakeholder engagement programme, hearing the views of 1,000 stakeholders and incorporating the views of over 11,000 households and 750 business customers, as well as including feedback from 300 stakeholder satisfaction surveys[5].

These stakeholder engagement exercises identified clear, cross-cutting themes regarding customers' willingness to pay for services that invest for the future. In June 2019, National Grid's 'Willingness to Pay' study found that customers are willing to pay more for service improvements in their gas and electricity provision[6]. Scottish and Southern Electricity Networks (SSEN) produced a 'Consumers' Willingness to Pay' study in July 2019 which found strong support among electricity customers towards investments needed for future changes in electricity supply and demand, and a strong willingness among customers to pay for investments to accommodate renewable energy[7].

In GIIA's view, the RIIO-2 Draft Determinations tend to over-prioritise consumer bill affordability to the detriment of long-term sustainable investment; investment that consumers have strongly stated as being a priority to them. Ultimately this prevents the industry continuing its transition towards being truly customer-centric businesses and raises the question of how useful such wide-ranging stakeholder engagement exercises are going to be in the future. Not only is this extensive stakeholder engagement expensive to run, it raises expectations that the results will be acted upon by the regulator and subsequently the operating companies. Plans

[1] Ofgem. Our Strategy (2014) URL
[2] Cadent, 2021-26 RIIO-2 Business Plan (2019), URL
[3] SSE Stakeholder Engagement Report, (2019), URL
[4] SGN, RIIO GD2 Business Plan (2019), URL
[5] National Grid, Stakeholder Engagement, URL
[6] National Grid, Willingness to Pay Study, (December 2019), URL
[7] SSEN, Consumers' Willingness to Pay, (July 2019), URL

that have been developed with such extensive stakeholder input should be given greater weight but if ultimately rejected the rationale for regulatory decisions to override them should be made much more transparent.

1.3 Intergenerational equity

The Draft Determinations place additional cost pressures on network companies and disincentivise investment in this five-year control period. One of the impacts of this approach will be to load even more costs for future essential investment on to consumer bills beyond the period, which is neither cost efficient nor fair in terms of intergenerational equity. The deferment of investment to future price controls does not adequately account for the interests of future customers and neither does it uphold the principles of intergenerational equity outlined as a priority within Ofgem's strategic objectives[8].

Another area of concern relating to the impact on future customers is in company efficiency benchmarking. For example, there may be occasions when a network company identifies new and innovate ways of working or processes that set a new benchmark for efficiency above and beyond the level prescribed in the Draft Determinations, which are limited to this five-year price control period. This company-led innovation may yield benefits beyond the price control and can be multiplied many times over. It is unclear whether Ofgem has taken account of the possibilities of innovations which could reduce the costs to consumers in the future. Instead the RIIO-2 Draft Determinations reduce the scale of incentives for high performance and innovation from companies.

The Draft Determinations prioritise short-term bill reductions over investment in asset maintenance activity, resilience and environmental improvements, creating a bow wave of costs for future customers to bear. Sub-optimal levels of investment mean costs will be higher in the long run creating significant intergenerational inequity and poor value for money compared to the proposals within existing business plans. If companies across the sector fail to meet underfunded performance commitments, this will have the knock-on effect of undermining the reputation of the industry as a whole and the legitimacy of its regulators.

1.4 Drive to shorter-term debt financing

By moving to a markedly shorter debt average to calculate regulatory cost of debt, under the Draft Determinations the regulated companies will be driven towards shorter-term debt to finance investment in long-term assets. Under the Draft Determinations, this is the only way companies will be able to meet and outperform the cost of debt benchmark. The proposals thereby promote riskier funding and could threaten the long-term stability of the industry.

2. Section two: opportunity cost of missed investment

2.1 Net Zero delivery, network resilience

Private investment in infrastructure will play a vital role in realising the UK Government's 2050 Net Zero ambitions. The Annual Report of the Committee on Climate Change (CCC) 2020 recognises the vital role that private capital will play in building Net Zero and climate resilient infrastructure, as well as restarting the economy and creating jobs[9]. Supporting these findings,

[8] Ofgem. Our Strategy (2014) URL
[9] Committee on Climate Change, Annual Report and Accounts (2020), URL

the World Wide Fund for Nature (WWF) identifies up to £90bn in annual benefits to the UK from a Net Zero transition, and estimates that investment in low-carbon infrastructure can boost long-term productivity and high returns, with every pound spent on low carbon investment resulting in a return of 3-8 times the initial investment[10].

The RIIO-2 Draft Determinations do not create the investment framework conducive to meeting Net Zero targets due to the limitations of the incentive regime. The combination of lowered returns and removal of several Net Zero-related investments from companies' base plans will make it challenging to mobilise and dedicate resources to meet the significant investment required to transform the UK energy system.

Key players in the UK energy sector have raised concerns over the Draft Determinations' negative impact on the delivery of a resilient and reliable network[11], as well as the fact that investments proposed in business plans were based on what is necessary to build a network capable of supporting the Net Zero transition[12]. In GIIA's view this is a missed opportunity to ensure that the energy sector supports the UK Government's ambition to boost investment in green infrastructure to drive the COVID-19 recovery and accelerate towards Net Zero.

2.2 Investor sentiment towards the UK

The Draft Determinations sit against a backdrop of significant risks facing investors. Continuing to attract investment will require a stable policy and regulatory environment, particularly following the end of the Brexit transition period. However, the current UK regulatory environment as set out in the Draft Determinations compares poorly to the UK's EU neighbours. Germany, for example, has developed a clear and cohesive hydrogen strategy[13], leading to capital flows being redirected from the UK and into low risk, yet innovative projects across Europe.

Recovering from the impact of COVID-19 and steering the UK towards Net Zero will require the UK to be seen as an attractive destination for domestic and international investment. This requires investors to be confident in the long-term stability of capital which can be achieved by developing a regulatory framework that encourages investment rather than penalises private investors.

The Draft Determinations propose a 50% reduction in investor returns and a 20% reduction in the planned network investment programmes despite the potential impact on service quality, jobs and the UK's Net Zero agenda. Investor sentiment across UK infrastructure has already been negatively affected by Ofwat's PR19 outcome and we would urge Ofgem to avoid further damage to the UK's reputation in the eyes of infrastructure investors more broadly.

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[10] WWF, A UK Investment Strategy (2020), URL
[11] National Grid, Ofgem's Draft Determination for RIIO-T2 (2020), URL
[12] SSE, SSEN Transmission Response to Ofgem Draft Determination of RIIO-T2 Price Control (2020), URL
[13] German Federal Government, The National Hydrogen Strategy (2020), URL

3. Section three: at odds with government's wider strategic direction

3.3 Attracting private investment and FDI (competition with other countries)

In calling for representations to inform policy development of the Comprehensive Spending Review, the UK Government has made clear that it seeks to find ways in which investment in infrastructure can be supportive in 'closing the gap with competitors by spreading opportunity, maximising productivity and improving the value add of each hour worked'[14]. The Prime Minister and Chancellor of the Exchequer have reiterated this sentiment by unveiling a new Infrastructure Delivery Taskforce to ensure that the UK can develop, design and deliver vital infrastructure projects better and faster than before[15]. GIIA members are concerned that the Draft Determinations undermine this ambition by significantly reducing capital expenditure by £8bn whilst setting out conflicting objectives between enhancing network reliability in the face of climate change risks and reducing costs to consumers. The UK risks losing important sources of FDI to other countries which have comparatively clearer and more stable regulatory regimes.

3.4 Levelling Up agenda

Research by National Grid has found that the transition to Net Zero will require the creation of 400,000 new jobs between 2020 to 2050, with significant employment opportunities in the North, Midlands and devolved nations of Scotland, Wales and Northern Ireland[16]. Achieving this level of employment demands significant investment in training across skills as broad as machine learning, data analysis, civil, mechanical and electrical engineering, as well as in new areas related to electric vehicles, hydrogen and carbon capture.

The proposed 20% reduction in the planned network investment programme is not consistent with the impact on companies' ability to generate such important employment opportunities that will support the Government in its 'Levelling Up' agenda.

3.5 Pandemic recovery

Investment in the economic recovery presents a unique opportunity to take bold action which will have a positive long-term impact such as creating employment. Government, businesses and regulators must work together to ensure the UK has a healthy and resilient future ahead. The resilience of energy companies has been challenged by the effects of COVID-19 and the Draft Determinations present an unwelcome hurdle for companies who are determined to play their part in supporting the economic recovery and transition to Net Zero.

Conclusion

GIIA is aware of the various balances that need to be struck in order to develop an effective regulatory environment. However, as outlined in our submission, we do not consider that the RIIO-2 Draft Determinations currently strike the right balance between short-term affordability for the consumer and the need for longer term investment to address resilience and climate change challenges. Moreover, the Draft Determinations prioritise short-term bill reductions and we are concerned that this will lead to intergenerational inequity by creating a bow wave

[14] HM Treasury, Comprehensive Spending Review 2020 representations: Guidance (2020), URL
[15] Prime Minister's Office, A New Deal for Britain (2020), URL
[16] National Grid, Building the Net Zero Energy Workforce (2020), URL

of costs for future customers to bear. The regulatory framework must go further to incentivise, rather than penalise the unavoidable investment in energy infrastructure that the UK will need over the coming years. With a suitably supportive environment, investors will be better placed to help steer the UK's transition to Net Zero with a renewed confidence in the long-term stability of capital.