RIIO-2 CHALLENGE GROUP

RESPONSE TO RIIO-2 DRAFT DETERMINATIONS

4 September 2020

Electricity and Gas Transmission, Gas Distribution and Electricity System Operator sectors

RIIO-2 Challenge Group

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Executive summary

The Challenge Group welcomes Ofgem's Draft Determination (DD). It addresses most of the main points that we raised in our submission on the companies' business plans, and in our view provides a good basis for the future of the relevant energy networks.

We are supportive of the approach that Ofgem has taken to identifying baseline expenditure based on well justified need and independently evidenced costs. We note that, for some plans, there are a number of areas where the evidence submitted by companies to support costs and volumes was weak, and we agree with the methodology that has been adopted to forecast baseline allowances. We agree with the ongoing efficiency challenge that Ofgem has applied.

We also agree with the move towards a more flexible model of **adaptive regulation**, with a greater proportion of company spending subject to uncertainty mechanisms (UMs) or reopeners. This seems the right response to the huge uncertainty facing the sector, particularly around the path to NetZero and also around the required level of gas mains repex.

However, it is important that both Ofgem and the Government recognise that, with a large proportion of expenditure still needing to be carefully scrutinised within the RIIO-2 period, there will be considerable pressure on **Ofgem's capabilities and resources** to ensure that this expenditure is both justified and also efficiently delivered in a timely fashion. It also requires a continuing commitment to **enhanced engagement**, to ensure appropriate governance and transparency. This means that there will be a continuing role for the User Groups (UGs) and Consumer Engagement Groups (CEGs).

On **finance and the allowed cost of capital** we wholeheartedly support Ofgem's robust and rigorous stance. Indeed, we are a little disappointed that Ofgem has proposed a set of financial parameters which are on balance more generous than those contained in the Sector Specific Methodology Decision (SSMD), since the 'flight to quality' post-Covid-19 and the inflation protection afforded by the proposed settlement have increased the market attractiveness of the network companies. We also think that a higher proportion of expenditure governed by UMs and re-openers will reduce sector risk still further. Nor are we convinced that there is any compelling reason to reduce the **outperformance 'wedge'** from 0.5% to 0.25%.

The DD says little about how Ofgem has factored in the considerable amount of **stakeholder engagement** carried out in support of the companies' business plans. We believe that Ofgem should set out how it has evaluated this activity, how it has considered the views of the UGs and CEGs, and how it has used this evidence in its decision-making. We also think there is good reason to maintain, and indeed to strengthen, the role of the UGs and CEGs – they could hold the companies to account for the delivery of outputs, scrutinise ongoing stakeholder and consumer research and provide a stakeholder challenge for the companies and Ofgem on decisions taken in the price control period.

The **outputs** required of the companies are generally appropriate with challenging targets, although we feel that the incentives on companies to deliver them could in places be stronger. In particular, we have concerns about the **balance between 'hard' financial incentives, Price Control Deliverables (PCDs) and Licence Obligations (LOs), and 'soft' reputational incentives,** particularly in the areas of Environmental Action Plans (EAPs) and in the outputs designed to support consumers in vulnerable circumstances. We also feel that stronger incentives such as Licence Obligations may be needed to provide assurance that Network Asset Risk Metric (NARM) outputs will be delivered to ensure the integrity of the networks.

We generally agree with Ofgem's assessments of the companies' performance in respect of the **Business plan incentives (BPI)**, although we feel that more weight should have been given to the importance of a company providing a high-quality early draft of its plan. It is much more difficult for Ofgem and other stakeholders to assess Information and analysis which is provided late in the process. We also agree that few of the Customer value proposition (**CVP)** proposals merited reward, although the specific reasons for acceptance or rejection of them were not always clear.

We support Ofgem's approach to **regulating the Electricity System Operator (ESO)**, but it will require a significant input from Ofgem to oversee the ESO's activities to ensure that it is innovative, flexible, and efficient. In addition, while the ESO has a major role in promoting the efficient transmission and distribution of energy, using both network and non-network tools, it cannot do it by itself. There will be differences in vision, incentives, and delivery decisions between the ESO and other network companies, especially their parent, National Grid. Ofgem will need to address these differences and play a major role in the drive to an efficient **whole system solution**. This adds weight to our earlier observation that Ofgem will need significantly greater capability and resource to carry out its own role effectively.

1. Introduction

In preparing our response we have focused on the following:

- Totex and uncertainty mechanisms
- Net zero and whole system
- Innovation, efficiency, and competition
- Finance and financeability
- Stakeholder engagement
- Outputs
- Business plan incentive and Consumer value proposition
- the ESO.

This main section includes our overall response to the DD in each area, covering the questions asked in Ofgem's core and sector consultation documents. Our responses to further questions asked by Ofgem are included as Annex 1.

2. Totex and uncertainty mechanisms

Electricity and gas transmission companies

We welcome the approach that Ofgem has taken to identifying baseline transmission expenditure based on well justified need and independently evidenced costs. We note that there are many areas where the evidence submitted by companies to support costs and volumes was weak and we agree with the methodology that has been adopted to forecast baseline allowances. We agree with Ofgem's examination of the companies' historical actual costs in efficiently delivering safe, reliable, and environmentally sustainable networks. We welcome the ongoing efficiency challenge.

We welcome an approach for uncertain load related or replacement expenditure where only projects with a clear needs case are included in baseline expenditure and have a PCD output wherever possible. We also welcome the approach that has been applied to the assessment of other expenditure categories resulting in significantly lower baseline levels. Our comments on electricity transmission companies are:

- **NGET** – we consider costs and volumes provided by NGET to be poorly justified and we agree with the proposed reductions to baseline totex expenditure. We also welcome the proposal to claw back some £550m of expenditure from RIIO-1. This addresses our concern that RIIO-1 expenditure was inefficiently deferred and is being claimed again in RIIO-2.

  For Non-Load Related Expenditure (NLRE), while we recognise that NARMs metrics must be considered alongside actual asset condition data, the proposed output level after NLRE reductions may not provide reliable assets for consumers. The Ofgem analysis identifies concerns about the quality of NGET asset risk data and we hope this issue is resolved by final proposals. If not, we suggest Ofgem gives NGET a deadline to address this concern early in the price control period.

- **SPT** – overall, we agree with Ofgem's proposals for cost and volume reductions and note that SPT has been invited to provide additional information for certain cost forecasts.
- **SHET** – in our January report to Ofgem, we highlighted concerns about the uncertainty of cost and volume justifications and requested that Ofgem examine these further. Overall, we agree with Ofgem's proposals for cost and volume reductions, including the observation that additional network complexity does not justify the claimed increases. On load related expenditure, we would suggest that the £92m Kinardochy reactive compensation solution is sufficiently uncertain to be excluded from the baseline.

For gas transmission and NGGT, we welcome the approach that Ofgem has taken to identifying baseline transmission expenditure based on well justified need and independently evidenced costs. The Atkins Engineering Assessment and Faithful & Gould Asset Health Unit Cost Review provide a detailed review and we are pleased that Ofgem has taken this into account. The detailed review also provides an opportunity for NGGT to present additional evidence.

We note recent press reports[1] stating that National Grid had terminated the £113m contract to upgrade compressor stations at Peterborough and Huntingdon due to costs allegedly doubling. We are surprised by this apparent development given that NGGT's RIIO-2 business plan had shown this project to be on track. This illustrates our concern about NGGT's delivery and cost management capabilities, and business plan forecasts. We think this supports the Ofgem proposal to put such projects into UMs.

Flexibility - We welcome the flexibility provided by the uncertainty mechanisms that Ofgem has proposed. They strike a good balance between ensuring that the baseline expenditure can proceed and enabling additional efficient expenditure to be funded once the need is clearly identified.

We generally agree with the UMs that Ofgem has proposed. We agree with the Ofgem proposals for reopeners, cross sector pass through and indexation. For electricity transmission, we agree that the proposed approach for volume drivers for connections and reactors is appropriate. Based on past experience, we do not consider that volume drivers are suitable for boundary reinforcements and that these should be subject in all cases to reopeners and bespoke PCDs.

It will be important for Ofgem to put appropriate governance and resourcing in place to ensure that the uncertainty regime can be implemented effectively. There may be useful experience to be gained from Ofgem's experience of Transmission Investment for Renewable Generation (TIRG) and Strategic Wider Works (SWW) project delivery.

Gas distribution

During RIIO-1, all Gas Distribution Networks (GDNs) significantly underspent their totex allowances and we welcome Ofgem's proposed reductions from GDN forecasts. Overall, we support Ofgem's evidence-based approach of identifying baseline expenditure based on a top down regression analysis of GDN costs supported by benchmarking and technical assessment. We agree that an ongoing efficiency challenge is important. However, we are concerned that the use of GDN forecast costs for RIIO-2, above current run rates, may lead to higher than necessary expenditure

[1] https://www.constructionenquirer.com/2020/06/29/costain-and-national-grid-bust-up-over-costs-of-113m-job/

profiles. The GDN network is experiencing falling gas demand and it is quite possible that this will continue (especially considering the £2bn home efficiency improvement programme the government is launching in September 2020). Lower demand may be expected to result in falling costs particularly in the low-pressure networks.

We welcome the fact that £860m of non-mandatory repex has been removed. We support the use of 16-year payback periods for repex and capex investments, thereby reducing the risk of stranded assets. We suggest GDNs should report the Green House Gas (GHG) saving for mains replacement based on cost per tonne of carbon dioxide equivalent to provide transparency of the GHG benefit from mains replacement.

Given future uncertainty about gas demand and asset utilisation, we think the minimum amount of expenditure necessary to deliver a safe, reliable, environmentally sustainable network should be included in the baseline and the remainder addressed through uncertainty mechanisms.

Flexibility - We generally agree with all the UMs that Ofgem has proposed. We agree with the Ofgem proposals for reopeners, pass throughs, volume drivers and indexation. In particular, we welcome the reopeners for heat policy and Health & Safety Executive (HSE) policy changes. For the latter, we would urge Ofgem to take the lead in addressing, with the HSE and Government, the future of the iron mains replacement programme, taking into account safety, reliability, environmental sustainability and any potential implications related to repurposing of the gas network for hydrogen.

3. Net zero and whole system

Net Zero – We welcome the approach that Ofgem has taken to NetZero with the £3.5bn of baseline funding together with a range of uncertainty mechanisms that may be triggered when investment needs become clearer. The DD recognises the scale of the NetZero challenge and the adaptive regulatory approach needed to address the uncertainties involved.

We welcome the innovation initiatives and trials that are proposed. Demonstration projects will provide valuable evidence to support future strategic decisions. We would like to see such initiatives being as open as possible to new ideas and third parties and being an enabler for future competition in the provision of new NetZero assets and services. The Strategic Investment Fund should provide a valuable additional source of funding for major projects.

We do not think it appropriate that a ‘blank cheque’ should be provided to regulated companies for NetZero. We welcome the fact that the NetZero baseline anticipatory investment (such as ESO funding) has been limited to high confidence areas.

We would like to see transparency over the allocation and reporting of all NetZero spending so that progress and value for money can be assessed.

Establishing appropriate governance and transparency for customers and stakeholders about the funding of NetZero uncertainty mechanisms will be critical. This level of change in price controls will increase the need for Ofgem to make timely decisions about large expenditures that are potentially critical for the achievement of NetZero. Ofgem will need to have the governance, resources, and agility to make these decisions.

We suggest that Ofgem should take a strong leadership role in addressing NetZero challenges, developing a strategy, ensuring the necessary coordination, and driving change through the RIIO-2 regulatory regime and its associated powers.

Whole system - we welcome the fact that Ofgem has recognised the importance of a whole system approach, and the regulatory regime that has been established to enable the ESO to play a key role in delivering Whole System benefits. Analysis by Imperial College suggests that some £8bn per annum of savings[2] may be realised by 2030 through a more digitalised, dynamic, and whole system approach to power system planning and operation. The ESO has a key role to play across the whole system of energy production, consumption, and network assets to realise these future benefits.

It is also welcome that the DD includes investment in significant initiatives that should help to deliver these benefits, but we are concerned that there is a lack of coordination between Ofgem's regulatory regime, the ESO plan and network company plans (for both transmission and distribution networks) which may delay new initiatives and put these benefits at risk. For example:

- whereas Distribution Network Owner (DNO) plans for RIIO-ED1 included smart grid benefits, the Transmission Owner (TO) company plans do not include Whole System benefits that are expected to result from the ESO's new initiatives
- the ESO plan does not appear to be coordinated with DNO and their associated Distribution System Operator (DSO) plans. Benefits from greater exploitation of distributed energy resources may not be realised
- the ESO plan does not include proposals for a review of security standards. Benefits from operating a dynamic, digitalised system with lower security standards, where the ESO actively pursues new operating and planning regimes, may not be realised
- the ESO Network Option Assessment (NOA) process appears to prioritise network solutions over non-network solutions. Less costly solutions may not be pursued. We are concerned that the NOA process undertaken by the ESO does not effectively consider the optimum future development scenarios, and the interaction between network and non-network solutions. This will require consideration between incremental and strategic solutions. We suggest that a review of the NOA methodology be undertaken to ensure that it can address these issues.

We think this apparent lack of coordination risks undermining the adaptive and agile approach that is needed for the energy transition. It presents a significant risk to the realisation of Whole System benefits. An adaptive regulatory regime has been established for the ESO through the 2-year plan reviews, and the TOs through uncertainty mechanisms. As for NetZero, Ofgem will need to establish appropriate governance, resources, and internal capabilities to perform this Whole System leadership role in an agile manner, so that the benefits can be realised.

We think there is a key leadership role for Ofgem to ensure clear coordination and direction in pursuit of these benefits. The ESO decisions on network or other solutions will impact other companies so there needs to be a clear approach to agreeing solutions or resolving disputes. Responsibilities, including Ofgem's, should be made clearer.

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[2] Pöyry Consulting and Imperial College London "*Roadmap for flexibility services to 2030*", Report to the CCC, 2017, https://www.theccc.org.uk/publication/roadmap-for-flexibility-services-to-2030-poyry-and-imperial-college-london/

4. Innovation, efficiency and competition

Innovation - we welcome the approach that Ofgem has taken to supporting innovation across NetZero, Whole System and efficiency improvements. The coordination of innovation initiatives, for example for hydrogen, is welcome.

We agree that access to innovation funding should be as widely available as possible, enabling new ideas and capabilities (including from outside the established players), and should be designed to enhance competition in the provision of assets and services wherever possible.

Innovation funding processes should be clearly defined and transparent. Ofgem should retain overall governance and control of funding through price controls, while ensuring effective coordination with other funding initiatives.

Real Price Effects (RPEs) and efficiency – we welcome the methodology that Ofgem has used to calculate RPEs and that the forecast RPEs will be included in allowances with an ex-post true-up. The inclusion of RPEs should reduce risks of input price differentials for the companies.

We agree with Ofgem's proposals for an ongoing efficiency challenge of 1.2% for capex and 1.4% for opex for all network companies, and that some of this should result from previously funded innovation investment.

Competition – we think it is critical that Ofgem commences competition in the design, financing and delivery of network solutions, releasing benefits to consumers.

We agree with Ofgem's proposals to apply competition to projects that are subject to UMs. We welcome the fact that companies must carry out necessary preparatory works in a way that is not detrimental to competition; we suggest that Ofgem considers how this obligation may best be enforced.

We note that Ofgem proposes that connection assets remain in baseline expenditure and not subject to competition. We suggest that, once competition in provision of electricity transmission is enabled, then such connections should be available for competitive development by the equivalent of Independent Connection Providers (ICPs) and Independent Distribution Network Owners (IDNOs). This may require Ofgem's competition qualifying criteria to be reassessed.

5. Finance and financeability

We greatly welcome and appreciate the extent of the rigorous research and modelling work which underpin the financing aspects of the DD. However, although there are aspects of the proposed settlement which have tightened since the May 2019 consultation, there are a number of areas in which Ofgem has increased allowances and in which it could, in our view with advantage, have been more stringent.

Any settlement must strike a fair balance between the interests of the relevant stakeholders, principally shareholders and consumers. We are clear that there is, at least so far, nothing in the Covid-19 situation that would prompt a requirement for a settlement which is more generous to shareholders than was necessary before the crisis. On the contrary, the 'flight to quality' (and especially utilities with an inflation-proofed regulatory environment) would indicate that there is little need to be preoccupied about the availability of either equity or debt funding, underlined by the robust performance of utility shares (including National Grid) which performed significantly better than the market in the sell-off which marked the early phase of the pandemic. Bond yields for utilities are also down, pointing to the ready availability of well-priced debt. Consumers, by contrast, are clearly facing a period of exceptional hardship which is unlikely to have been resolved before the start of the control period. We would like to see the balance between the interests of consumers and shareholders redressed to take greater account of the position of the former.

We also believe that the DD could, with advantage, have laid greater emphasis on the need for relevant customer engagement in relation to financing. Several of the companies made the point, either in their business plans or orally to us, that customer engagement is particularly difficult in relation to financing. There may be an element of truth in this but we take the view that, provided engagement methods are appropriate, suitably informed consumers ought to be in a position to make an effective contribution (for example only, in our group's suggestion that appropriate customers should be engaged on the provisions in early draft business plans in relation to asset lives and target ratings). In any case, we note that consumers were able to engage in discussions about totex which is, in a different way, also a highly technical matter. We do think that, in the instances where at least a measure of consultation in relation to financing *had* taken place, it would have been helpful if the DD had shown more clearly how these views had been taken into consideration.

We take the view that, overall, systematic risk in the energy sector is low and that aspects of the DD such as the inflation pass through e.g. equity, debt, RPEs, and wide-ranging uncertainty mechanisms have further lowered the risk profile for the upcoming control period. We would have liked this lower risk profile to have been reflected to a greater extent in the cost of capital allowances. In that context, we obviously welcome the proposed reduction in the headline cost of equity allowance (from 4.3% to 3.95%) but note that this proposal is a good deal less stringent than it might appear: around half the reduction reflects changes in the risk free rate which is, in turn, indexed and the other half is offset by a combination of the newly-introduced 17 basis points (bps) of allowance for debt issuance costs and, although with lesser impact, the proposed £75m for equity issuance costs (which we note is payable whether or not it is used). In addition, the proposed ex-post review of the 25bps outperformance wedge mean that the companies are more likely to earn it. The overall impact is that the cost of capital allowances are significantly more favourable to the companies than Ofgem proposed in their May 2019 Sector Specific Methodology Decision (SSMD), even though market indications are that the cost of capital has reduced since that time.

There are several areas in which Ofgem has, in our view, been overly cautious and in which we consider that, in the light of the reduced risk profile implicit in the settlement, it was not necessary to be so. This is particularly so in relation to the Total Market Return (TMR) range where we can see no strong reason for settling on the middle, rather than the lower end, of the range. We think that key risks for the companies in the form of unexpected changes to expenditure profiles or the regulatory regime are significantly reduced by the DD and that, overall, the systemic risk profile of the sector remains very low. In our view, this is not captured in the small reduction to the equity beta which is, in any case, proposed only for the high end beta estimate.

We note also – and are in full agreement with – the commentary, based on a report from consultants CEPA and incorporated in the DD, which underlines the similarity in the regulatory regimes applicable to the energy and water sectors and the fact that the protection offered by the regulatory regimes in particular is such that the risk profile (and hence the returns on capital which are to be anticipated) of companies in those sectors are also very similar. Taken overall, we see no reason why either gas or electricity companies should benefit from higher returns on capital than those in the water sector. Some of the proposals in the DD (such as the wide-ranging provision for uncertainty mechanisms, the Return Adjustment Mechanism (RAM) and the ex-post true up on the outperformance wedge) would point to lower returns.

It is obviously important that the cost of equity allowance is set at a level which does not discourage necessary expenditure. We can see no evidence that that would be likely to be so at 3.95% (or 4.2% inclusive of the outperformance 'wedge' which, as noted above, is itself supported by the proposed ex-post adjustment). Market evidence since May 2019 (and cited in the DD) seems to us a clear indication that a cost of equity allowance at an even lower level would still be attractive to investors.

We are not convinced that the fact that a high proportion of totex is subject to uncertainty mechanisms in this control period will reduce the scope for companies to underspend. The reverse can be argued, with time pressures on decision making potentially increasing the 'asymmetry of information' effect. In short, a great deal will depend on Ofgem's capacity to evaluate requests for UM approvals. We consider that the histogram on p72 of the DD (which appears to be based on a good sample and time period) provides strong support for an expectation of out-performance, with a very high proportion of observations falling in the 0.9-1.0 category which, as the DD says (paragraph 3.123 of the Finance Annex), indicates an average underspend of about 7%. The 'tail' on either side of the central band is far from symmetrical with overspend at 10% low and minimal in excess of 10%. Against that background, we can see no convincing rationale for the 25bps reduction in the outperformance wedge. In our view, the evidence provided in the DD supports maintaining the 'wedge' as previously proposed at 0.5% and that a reduction is even less necessary in the light of the ex-post true up proposal. We consider the combination of the reduction in the 'wedge' and the true up unnecessary to encourage appropriate investment.

The gearing requirements seem to us unnecessarily conservative. The requirement to move immediately to lower gearing (rather than allowing it to result from suspension of dividends, at least in the first instance) carries with it provision for around £75m of equity issuance costs in the first year (equivalent to an additional return of around 20bps in that year) which will need to be funded by consumers, even in instances where they are unlikely to be incurred. We also consider that this sits oddly with the tax clawback thresholds for gearing which are based on an assumption of gradual de-gearing. The benefit of the tax shield on higher borrowing is also not insignificant. We note that other sectors (with water particularly relevant) have been asked to exercise restraint over dividend payments in the light of the economic impact of the Covid-19 crisis. The requirement to move quickly to lower gearing is clearly driven by the conservative approach to target ratings and we accept that, with the potential for a no-deal Brexit and a 'second wave' of the Covid-19 crisis, there are uncertainties ahead and that a degree of caution is warranted. However we take the view that the resulting economic uncertainties are more likely to benefit the utilities sectors than the reverse and that, against that background, the clear minimum across the board BBB+ target ratings and a heavy focus on Adjusted Interest Cover Ratios (AICR),with apparently very little weight given to the significant headroom in the gearing ratio, may be overly conservative.

We accept that, in a very low interest scenario, higher target ratios (supported by lower gearing) have a negligible impact. However it seems to us (a) that the current very low interest rate environment could well not endure for the whole of the control period, and (b) imposing a requirement for immediate (as distinct from gradual) de-gearing carries unnecessary equity issuance costs and is not needed in the context of a DD which, taken as a whole, we consider constitutes a *reduction* in systemic risk. We also consider that the 17bps increase in the Cost of Debt allowance sits oddly with the proposal for lower gearing.

Overall, we think there is evidence, both within the DD itself and elsewhere, that Ofgem could have reduced the cost of capital allowances further while still maintaining returns attractive to investors. We recognise that Ofgem is seeking to determine a fair balance between the interests of investors and those of customers but hope that, in the final determination, Ofgem will take due note of the evidence which it has set out in the DD and highlighted above and which in our view points towards lower cost of capital allowances than are currently proposed.

6. Stakeholder engagement

In line with Ofgem's 'enhanced engagement' approach, a considerable amount of consumer and stakeholder engagement has been carried out to support the companies' business plans. However, the DD says little about how Ofgem has considered this insight and factored it into its decision making. Engagement is an iterative process, the success of which depends on each player understanding the impact of their feedback on decisions and, ultimately, on better outcomes. Network companies are rightly being held to account to provide evidence of how feedback from consumers, customers and stakeholders is driving decisions at all levels in their businesses. But Ofgem is also a key player in this process. In order to maintain trust in the process (including in the process that is already underway in the electricity distribution companies) Ofgem should provide in its FD a comprehensive explanation of: how it has evaluated the stakeholder engagement and consumer research carried out by the companies; and how it has considered the views of the UGs and CEGs. It should make clear how it has used this evidence in its decision making, and where it has traded it off against other factors.

An enduring role for the customer groups

Ofgem asks for views about any ongoing role for the UGs and CEGs. We believe that the groups can play an important role during the RIIO-2 period. The groups' potential comes from their: having been close to the original development of the plans; having a deep understanding of their company and its sector; and having developed effective relationships with the executives and non-executives responsible for the companies' performance, while maintaining robust independence.

In summary we think the company groups can be most effective by:

- Holding the companies to account for the outputs they are obliged or incentivised to deliver during the price control, covering Output Delivery Incentives (ODIs), Price Control Deliverables (PCDs), Licence Obligations (LOs) and Environmental Action Plan (EAP) commitments. This will be particularly important as we have identified a risk that companies may not deliver some outputs or may not deliver them to a sufficient quality (see 'Outputs', p14 for more on this).
- Continuing to scrutinise the stakeholder or consumer research that is used to support investment proposals developed through the uncertainty mechanisms. More generally, they will be well placed to provide a consumer voice and stakeholder challenge to companies and Ofgem on major decisions taken during the price control

- Being demonstrably independent of the companies - for example, by using a range of sources of information to challenge the companies, not just that provided by the companies themselves which could also include non-network solutions
- In their annual reports, providing both their views of how the company is delivering on its business plan promises, and an evaluation of how the group's work is ensuring companies are delivering benefits to customers and consumers.

The groups should also be able to provide effective continuity in the process of determining the RIIO-3 price control. Their effectiveness here should lie in: their ability to provide Ofgem with real-world insights into how network companies respond to different price control mechanisms; and their ability to identify and challenge any disconnect between the ongoing delivery of RIIO-2 plans and company claims made in business plans for the RIIO-3 period. In particular, they should be able to provide insight into whether expenditure and outputs are simply being deferred to RIIO-3.

In combination, these factors should help redress some of the inevitable imbalance of information, understanding and 'institutional memory' that exists between the regulator and the network companies, and which can ultimately limit the regulator's impact on behalf of consumers. In order to derive these benefits, we believe it will be most effective to retain the groups at a company level.

We do not think that the groups are best placed to undertake detailed expenditure or other analysis which is best performed by Ofgem e.g. detailed expenditure analysis or value for money assessments across companies. It will also be important for Ofgem to reset its expectations for the groups at the start of the RIIO-2 period, based on lessons learned during the business planning phase, and on its new regulatory contract with each company, once those are finally determined.

Ofgem could further support the impact of the groups in a number of ways.

- It should require each group to publish an annual report - addressed to consumers, customers and stakeholders – with its view of how the company is delivering on its business plan promises, and an evaluation of how the group's work is ensuring companies are delivering benefits to customers and consumers. These reports could provide a useful, qualitative complement to the comparative quantitative data on company performance published by Ofgem. In order to boost the reputational impact of these reports, network companies should be required to distribute them prominently and widely to customers and stakeholders. Ofgem could also consider requiring energy supply companies to publicise these reports to consumers who are paying for network company costs through their bills.
- Ofgem should also consider giving the groups the ability, and expectation, to escalate any significant concerns to the regulator during the price control period (if these points have not been adequately addressed by the company having first been raised with its Board). This could be a trigger for enforcement action if justified. (Note: The Financial Conduct Authority sets a similar expectation for the Independent Governance Committees that have to be maintained by providers of workplace pension schemes[3]).
- The effectiveness of the individual groups would also be enhanced by collaboration between the groups at sector or cross-sector level. This could involve either group chairs, or a sub-set of them, with a Chair and associated secretariat support appointed on rotation from among the company groups. This cross-sector group, which should have an ongoing dialogue with

[3] See www.fca.org.uk/firms/independent-governance-committees for more detail.

Ofgem, could work to identify and resolve those issues that are best dealt with at a sector or cross-sector level. However, in order to be effective, any cross-sectoral group would need Terms of Reference that require the companies to respond to its recommendations.

Bespoke stakeholder engagement outputs

A number of companies proposed bespoke outputs in the area of stakeholder engagement. Most have been rejected by Ofgem. We think this is reasonable for the reasons set out in our original report. Several companies proposed output mechanisms to hold themselves to account for delivery of their stakeholder engagement activities. This is welcome but, culturally, we think it is better to see this type of public accountability for engagement as business as usual.

A few companies proposed incentives to encourage them to undertake engagement in newer areas of focus (Cadent - whole system solutions; SPT - vulnerable customers' resilience during Black Starts). Again, these are important developments, but we think it is now right to expect companies to be identifying and engaging on priority issues and with priority customer groups as a matter of course. That said, Ofgem should make clear what action it would take if companies are identified as falling short in their engagement activities.

7. Outputs

We have identified a potential risk that network companies may not deliver the outputs promised by their plans or may not deliver them to the quality required to achieve the right outcomes for customers. We have particular concerns around valuable outputs including the Environmental Action Plans, and some of the outputs designed to support consumers in vulnerable circumstances. We believe this is a risk because of a combination of factors including: the limited financial incentive to perform in the draft regime; and the increased reliance on reputational incentives to drive outputs.

As we have set out elsewhere, we strongly support Ofgem's drive for efficiency. But it is essential that efficiencies are delivered by doing the same or more for less. It is crucial that companies do not feel able to take reputational risk by cutting back or reducing the quality of outputs that customers need and value. We would urge Ofgem in its FD to consider the scale of this potential risk to output delivery, and to take steps to limit this risk as appropriate. These steps could include:

- reclassifying some outputs as PCDs, Output Delivery Incentives – Financial (ODI-Fs) or LOs rather than Output Delivery Incentives – Reputational (ODI-Rs).
- strengthening the power of reputational incentives by establishing a licence obligation for companies to publish information on how they have delivered on these outputs
- setting out clearly how Ofgem will take account of any non- or under-delivery of ODI-Rs in its RIIO-3 determinations
- identifying the role that CEGs and UG could play in holding companies to account for the delivery of outputs, and how best Ofgem could support them in those efforts.

Customer outputs

As we said in our original report, we support the principle that improved service levels from RIIO-2 should now be expected as business-as-usual. Good current service levels should be protected by penalties that kick-in quickly if service levels start to drop, and additional rewards should only be provided if significantly improved service standards are achieved. We think that Ofgem's proposals in this area generally meet these objectives.

<u>Outputs related to vulnerability</u>

The vulnerability package in the DD increases spending overall compared with GD1 (with increases in spend on Use-It-Or-Lose-It (UIOLI) and banked frontier in some places, offset by less spending on affordability measures). But we question whether this package is ambitious enough, especially in light of Covid-19. Given the likely increase in consumer vulnerability in the 18 months since Ofgem first proposed £30m spend in this area, and the amount of focus which the companies and CEGs put into the draft business plans in this area, it is surprising that Ofgem has left the level of spend unchanged and simply apportioned it pretty much pro rata.

We think Ofgem should consider the impact of Covid-19 on this package ahead of FD. For example, should there be a reopener, or expansion of the UIOLI mechanism to reflect decreased affordability, increased vulnerability, debt and employment that people are likely to face in the period?

We also have concerns about the large number of bespoke measures disallowed which could have provided valuable outcomes for consumers. We are concerned that the companies may not devote sufficient time to providing additional evidence in this area ahead of the FD when their priorities may lie elsewhere.

<u>Environmental outputs</u>

We welcome the fact that Ofgem proposes to accept substantially all the commitments in the company Business Plans and Environmental Action Plans (EAPs), and agree with the finding (as identified in our January report) that all the companies' EAPs meet the minimum requirements. We strongly support the requirement for annual reporting in respect of all the commitments in the plans, and welcome the stated expectation that Annual Environmental Reports (AERs) will be adapted during RIIO2 to reflect emerging reporting conventions and standards so that progress in areas such as waste and recycling, carbon intensity of new network build and biodiversity and natural capital commitments can be measured with rigour and on a comparable basis. We hope that CEGs and UGs will challenge companies to put in place targets during the course of RIIO-2, where these have not yet been set, once baselines and measurement frameworks have been developed.

We also generally welcome the £160m baseline spend and additional money (through PCDs) for substantial commitments in relation to Sulphur Hexafluoride (SF6), compressor emissions, land remediation and fleet conversion. We think there is some more work to do to ensure that financial support for the introduction of Electric Vehicles (EVs) into fleets fully factors in savings to the companies in fuel costs and is judged against normal cycles for fleet replacement. We would also suggest that it is important that incentives to address vehicle emissions do not distort incentives to adopt the most appropriate technology (e.g. compressed natural gas (CNG) or hydrogen).

However, we have a few reservations about the overall framework for environmental outputs. First, while we understand Ofgem's desire for a consistent and uniform framework for environmental outputs, we do query the case for rejecting as PCDs, on grounds of materiality, a number of specific commitments which have been brought forward in this area in response to challenge from stakeholders. PCDs provide a more effective way to ensure that specific commitments are delivered or that revenue is returned to customers and do not necessarily need to involve extensive additional work on the part of Ofgem or the companies.

Second, we are concerned that there appears to be little or no reward for more ambitious EAPs or achievement which may mean that it could be easier for companies to deliver an acceptable, but unambitious plan (and there are very limited incentives in this area – only the NGET and NGGT balanced scorecard ODI-F, and the natural capital proposals accepted as a CVP). This is an area where there was evidence of strong consumer support for action to address environmental impact and where, as we noted in our January Report, CVP could be used to reward ambition and consumer value assessed across the total environmental package or where, potentially, the environmental scorecard approach put forward by NGET could have been adopted for all companies.

Finally, our January report commended companies who identified the issue of adaptation to climate change as important, and it is disappointing that this does not seem to have been given significant weight. We can see the logic in climate adaptation being treated as a resilience rather than an environmental issue, but we do think it will be increasingly important over the next control periods for companies to address systematically, and report to stakeholders, on climate adaptation. The AER would provide an obvious mechanism for this especially as it had already been included by some companies in their EAP, and we encourage Ofgem to consider its inclusion in the AER template.

8. Business plan incentive (BPI) and Consumer value proposition (CVP).

BPI Stage 1

The BPI was intended to incentivise the preparation and submission of ambitious plans containing the information required by Ofgem to undertake a robust assessment. We have reservations about the extent to which the qualitative aspects of the incentive have fulfilled their purpose.

In producing our January report we did not conduct a comprehensive review against minimum requirements and do not therefore feel that it is appropriate to comment specifically on the proposed penalties under Stage 1. Our January report identified the plans from NGET, NGGT and SHET as the weaker plans, reflecting a combination of weak evidence and poor engagement with us.

One purpose of the BPI is to ensure that business plans are subject to robust scrutiny prior to submission through the challenge process, and it is therefore crucial that there is enough information in the drafts to allow us to do that. We noted in our report that the July plans of the companies were in many places insufficient for us to make a full assessment and we would have liked this to be taken more explicitly into account.

BPI Stage 2 Consumer value proposition (CVP)

In our January Report we noted that the concept and methodology of the CVP as the primary differentiator of quality of reports which met minimum requirements was a late addition to the process which we had difficulty applying. We also noted that much of what the companies had put forward as delivering additional consumer value did not in our view go beyond what should be regarded as business-as-usual.

We identified a small number of proposals which we thought might have value but we also encouraged Ofgem to consider looking at and benchmarking the complete offering of companies in areas such as provision for consumers in vulnerable circumstances, service standards or environmental initiatives. This was because we were sceptical of the benefit of rewarding individual elements of a package which viewed as a whole was not particularly strong when, there would be more value for consumers from a plan which was strong across the board in a particular area.

The DD proposes three relatively minor (each less than £2m) rewards for CVP proposals and identifies an additional three proposals which would be eligible for reward if the companies had met the minimum requirements under Stage 1. The remaining 111 CVP proposals have been rejected. We note that all but one of the specific proposals highlighted for reward were among those we had identified as potentially offering additional value. Nonetheless, we have concerns about the robustness and transparency of the CVP process and the value it has delivered.

- We agree that aspects of plans which are eligible for reward through other mechanisms (notably totex incentive mechanism) should not be eligible for CVP.
- We also agree that very little of what was put forward actually went beyond business-as usual or appeared to offer additional value.
- We agree with Ofgem (and several of the CEGS/UGs) that things which are part of corporate social responsibility, while commendable, are not appropriate for reward under the BPI.
- Although brief reasons are given for rejection of the majority of CVP proposals the process of assessing CVPs has not been particularly transparent (we found it hard to see the logic for accepting one specific CVP in the GDN sector which related to an aspect of customer service which we understood to be business as usual for others).
- We thought that there were potentially aspects of the proposals relating to consumers in vulnerable circumstances which could have delivered additional value and which have been disregarded because of the approach Ofgem has chosen to adopt.
- We think that the emphasis on rewarding individual elements means that the overall quality and ambition of EAPs has not been assessed or recognised.
- We think that the process around annual reporting and claw-back may be disproportionate in relation to the size of the proposed rewards and that CEGs and UGs could hold companies to account during the price control, with claw-back for non-delivery retained as an option.

In the light of all these considerations we recommend that this element of the BPI should be re-evaluated for RIIO-ED2.

Regarding other business plan incentives (the sharing factors and confidence penalties) we agree with the methodology and evidence-based approach that has been used and the corresponding results. We welcome that further evidence may be considered before final determinations.

9. Electricity System Operator (ESO)

Overall, we welcome the ESO regime proposed by Ofgem. We agree that the ESO can unlock significant benefits for consumers in helping to shape the best pathway to NetZero. It can also unlock significant economic benefits from taking a coordinated, whole system approach to energy system planning and operation.

Ofgem's DD expects the ESO to develop its own vision for the system operator role and to place wider system and consumer interests at the heart of its decision making. While this is welcome, we think that Ofgem will need to provide a strong leadership role to ensure that the ESO delivers both NetZero and Whole System benefits (we outline this further in our comments on NetZero and Whole System). Ofgem will need to reconcile any differences in vision, incentives, and associated delivery decisions between the ESO and the electricity transmission and distribution companies, especially the ESO's parent company, National Grid.

Flexibility and uncertainty - We support the adaptive regulation approach proposed in the DD. The 2-year plan approach should give flexibility for the ESO to evolve into its new role while maintaining regulatory oversight.

Costs - We support the increase in funding provided to the ESO, recognising that this is uncertain and based on high-level forecasts. However, we do not think the ESO should be given a blank cheque. All expenditure should be transparently allocated and reported and be subject to value for money assessments.

Outputs and performance - We welcome the DD proposals for a more detailed set of outputs and performance measures which should improve ongoing ESO performance monitoring. We generally agree with the proposed approach for ongoing assessment and application of performance incentives but suggest that consideration be given to comparison of balancing cost performance against a 'perfect foresight' benchmark.

We suggest that performance measures and reporting requirements are developed further to ensure that they track progress towards the ESO's strategic goals of carbon-free operation and £2bn of benefits by 2025.

Incentives – We agree that the asymmetric incentive regime of -£6m to £15m applied to allowed returns of c£6m pa is proportionate to the scale of the business. We think the ESO price control must strike a balance between incentivising the ESO to deliver its plan and associated whole system benefits, while also ensuring that the ESO is incentivised to avoid wasteful expenditure, but not to such a degree that it becomes unduly risk-averse. It is important that the ESO should have sufficient ex-ante certainty not to deter expenditure in potentially high-risk Information Technology (IT) projects.

As the ESO has a pass-through of expenditure, we support an incentive where totex may be disallowed ex-post, noting that the proposed uncertainty mechanisms should provide ex-ante confidence that these projects will be funded. We note that potential disallowance has been capped at 10% of Regulated Asset Value (RAV) or c£12m pa and will be applied only under specific conditions. We think this approach is proportionate to the scale of the business.

Overall, we think it is important that the ESO is incentivised to deliver outputs. The price control should not guarantee profits, which will weaken the incentives to deliver the required outputs.

Innovation – innovation by the ESO that brings wider system benefits is critical. As such we think that a 5-year innovation time horizon is sensible given the longer timeframes expected for delivery of such transformational projects. We suggest that, subject to the necessary stakeholder reporting and monitoring systems being put in place, the ESO be given a 5-year innovation allowance with the last 3 years being contingent on ex-ante Ofgem approval. Furthermore, we suggest that innovation funding is excluded from potential disallowance so as to give the ESO confidence to proceed with innovation initiatives.

ESO IT capability – this is a key area of concern that we raised in our January report. The ESO's plan envisages it becoming a technology delivery company for a major digital transformation programme, extending well beyond the ESO. We consider ESO IT procurement and delivery remains a major cost and outcome risk, and that this should be closely monitored by Ofgem

We raised a concern in our January report about ESO IT services being controlled by their parent company. While the conflict issue is being addressed in the DD, we remain concerned about the ESO delivery capability. We support IT delivery being transferred to the ESO, but on the basis that they will need the associated governance and management capability for the procurement and delivery of a complex IT portfolio. There may, for example, be a need for the transfer of complex IT procurement resource from National Grid Group.

Financial returns – We support the DD approach to de-risk significantly the ESO's business so that it is responsible primarily for risks which are within its control. We share Ofgem's view that it is of central importance that the incentive and regulatory regime is balanced in such a way that the ESO is not deterred from taking on risks which may be necessary for the realisation of wider benefits for the system as a whole. We also accept that, because of the size of the ESO's equity base, the impact of small variances in permitted equity returns is not substantial in cash terms.

Nevertheless, and even without the proposed £1.9m of 'additional funding', we consider the returns proposed are generous for an entity with the risk profile now proposed for the ESO, and that such returns are particularly difficult to justify in the current economic climate. In our view, any such 'additional funding' should be for the purpose of meeting a clearly defined requirement and should be provided on a 'use it or lose it' basis.

On balance, and in the light of the whole system considerations, we think that the proposed return on capital allowances are acceptable provided that the totex disallowance – and the associated downside risk - is not removed from the arrangements and that the proposed £1.9 million pa of 'additional funding' is dealt with as discussed above.

Annex 1: Responses to questions

This annex provides responses to the individual questions from Ofgem's draft determinations (published 9 July 2020) for the RIIO-2 price control.

Comments on core and some sector-wide document questions are addressed in the main body of our response. Responses are provided in this annex for the following:

1. Finance
2. Electricity System Operator
3. NARM
4. Electricity Transmission sector
5. NGET
6. SPT
7. SHET
8. NGGT
9. Gas Distribution Sector
10. GDN company-specific questions
    a. Cadent
    b. NGN
    c. SGN
    d. WWU

1. Finance

FQ1 Do you agree with our approach to estimating efficient debt costs and setting allowances for debt costs?

In general, we support the indexation of the cost of debt allowance (which we note reduces companies' risk profiles) by an appropriate index but consider the inclusion of a 17bps allowance for transaction and liquidity costs unnecessarily generous.

FQ2 Do you agree with our proposal to use the iBoxx GBP Utilities 10+yr index rather than a combination of iBoxx GBP A and BBB 10 yr non-financial indices?

Although the principle of an index composed of companies which are as close a match for the network companies as possible appears in principle to be desirable, we have concerns about the proposal to use the iBoxx GBP Utilities 10 yr+ index for two reasons. Firstly, it does not have an explicit rating, making it difficult to assess whether the target financial ratios in the financeability assessments are compatible with it. Secondly, and importantly, it gives rise to an apparent requirement for a 17bps uplift for issuance costs which was not required in the context of the index previously used.

FQ3 Do you agree with our proposal that the RAV growth profile of SHET continues to be materially different to other networks and therefore warrants continuation of a bespoke RAV weighted allowance calculation?

In general, we consider it unnecessary to distinguish between the different transmission companies in this respect but this proposal reduces costs to consumers and, to that extent, we would not wish to be anything other than supportive of it.

FQ4 Do you have any views on the model to implement equity indexation, as published alongside this document (the WACC allowance model.xlsx) or on the annual update process?

We do not have a fundamental problem with equity indexation although we note that it reduces risk for the companies and take the view that that should be reflected in the underlying return on equity allowance. We are not opposed to the arrangements for annual update: the difficulty of estimating CPIH real rates means that there is a clear need to provide for potential adjustment of the mechanism.

FQ5 In light of RIIO-2 Draft Determinations and Ofwat's final determinations for PR19, do you believe that energy networks will hold similar systematic risk during RIIO-2 to water networks during PR19? We consider the systematic risk faced by the energy and water companies to be similar but, on balance, probably lower for the energy companies.

Important systematic risks faced by both sectors seem to us to be:

- Demand risk – to which none of the companies are exposed;
- Stranding risk – the cost of new assets are recovered through the RAV and depreciation;
- Extreme events such as weather – mitigated for all companies through the price control but on balance greater for water companies which are exposed to an element of both drought and flood risk;

- Expenditure risk – greatly mitigated for all companies through asset health investment, uncertainty mechanisms and sharing factors but with water companies nevertheless facing higher risks because of leakage issues;
- Change of law or policy (such as changes in tax rates or environmental standards) – substantially mitigated through price control mechanisms;
- Inflation risk – mitigated for all through the price control mechanisms.

However although, in our view overall regulatory risk is similar and mitigated both by the principles of the price controls and the track records of the two regulators, we consider the principal risk faced by both water and energy companies to be the risk of low regulatory returns and that the arrangements proposed in the DD are such that, very arguably, for RIIO-2 they are lower for the energy companies. We have in mind in particular the extent of the protection afforded by uncertainty mechanisms, RAM and the ex post review of the outperformance 'wedge'.

There are clearly some differences between the two sectors such as the risk of asset stranding to which the GDNs, in particular, are exposed to a much greater extent than the water companies – although we consider this risk to be very substantially mitigated by the proposed allowances for accelerated depreciation. Both energy and water companies face technical challenges, but water companies face significant construction and reputational challenges over leakage and exposure to weather risk (both drought and flood) which do not affect the energy network companies. We do not consider that these differences invalidate our overall conclusion that, although systematic risk between the energy network companies and the water companies is broadly similar, the arrangements proposed in the DD mean that, for RIIO-2, risk, and in particular, regulatory risk is lower for the energy network companies.

FQ6 Is there evidence of a material difference in systematic risk between:

(a) RIIO-1 and RIIO-2

In our view the arrangements proposed for RIIO-2, including the high proportion of totex which is subject to uncertainty mechanisms and the indexing of both equity and debt returns mean that, on balance, (and not ignoring the economic uncertainties likely during at least the early part of the control period) systematic risk will be lower in RIIO-2 than in RIIO-1.

(b) Distribution and transmission networks

There are clearly important uncertainties ahead for both distribution and transmission networks. Both face a future of uncertain investment requirements due to the energy transition, but we think that, in the light of the combination of ex ante regulatory protection and uncertainty mechanisms, systematic risk is probably not materially different.

(c) Gas transmission and electricity transmission.

Both GT and ET are exposed to uncertain capex requirements (with the former facing reduced demand and the latter demand growth. However, in both cases, the proposed settlement provides very substantial protection (both ex ante and through uncertainty mechanisms) with the result that we take the view that systematic risk is probably not materially different between the two.

FQ7 Do you have any views on how we should consider further the gearing impact on beta and cost of capital estimates?

We consider the analysis in Sections 3.68 to 3.74 is soundly based and that, in any case, within the gearing ranges under consideration, it is appropriate to regard WACC as invariant to gearing.

FQ8 Do you agree with our interpretation of cross-checks?

Broadly yes, but we note that several of the cross-checks indicate that the cost of equity has fallen more since the May 2019 SSMD than is reflected in the proposed cost of equity reduction of 35 bps (50 bps in investment manager forecasts and 40 bps in infrastructure funds). The OFTOs present a rather different (and higher) risk profile than the network companies, but the analysis of OFTO returns (especially now that investors are more familiar with the risks) also supports a reduction in returns.

FQ9 What is your view on the overall in-the-round assessment of allowed returns to equity? Is our judgement of 3.95% at 60% notional gearing reflective of the combined analysis through Steps 1, 2 and 3?

We consider that the analysis is sound but that there are several respects in which Ofgem has opted for a mid to upper figure within a range and that the combined effect is generous. This is particularly so in the light of the impact of Covid19 (well illustrated by Table 25).

FQ10 What is your view of the expected outperformance estimate of 0.25% at 60% notional gearing? Do you recommend alternative analysis techniques or do you have suggested improvements to the analytical files published alongside this consultation?

Ofgem's analysis (which we see no good basis to doubt) demonstrates that totex efficiency of 5-14% equates to 50bps equity return outperformance (paragraph 3.109). RIIO-1 totex outperformance is expected to be between 3.3% and 21% for all network companies except NGGT and all companies are proposing efficiency gains over RIIO-2. We take the view that, even with Ofgem's best efforts, outperformance is facilitated (rather than the reverse) by a large proportion of expenditure being subject to uncertainty mechanisms. The DD describes an assumption of 0.25% as 'cautious'; we consider it unnecessarily so. We take the view that all the analysis points to the maintenance of a 50 bps 'wedge' and we were disappointed to see the reduction.

FQ11 What is your view on an ex-post adjustment for baseline equity returns? Is there an alternative mechanism or implementation approach that you think could better meet our stated objectives? Do you have specific views on averaging, pooling or suggested simplifications?

We take the view that there are a number of respects in which the proposed settlement represents a reduction in risk for the companies and that the ex post adjustment represents an unnecessary transfer of risk to consumers from the companies, especially since the proposed outperformance 'wedge' is set at only 25 bps. We are particularly concerned by the proposal for a company-based adjustment and would have preferred to see this done on a sectoral basis (i.e. GD and GT/ET).

FQ12 Do you agree with our approach to assessing financeability?

As we said in our January report, in general we consider the companies took an insufficiently nuanced approach to financeability with an excessive emphasis on AICR and PMICR and insufficient justification for targeting ratings which were in most cases two notches above those required to satisfy the relevant licence condition. We take the view that greater consideration could have been given to the low gearing ratios proposed and that this results in the target AICR ratios being higher than necessary. We accept that a degree of resilience is desirable at a time like this but take the view that the uncertainties associated with the potential for a no deal Brexit and the COVID-19 related economic risks are both likely to favour utilities relative to other investments and do not justify the 'cushion' inherent in the proposed target ratios (and hence the target ratings).

FQ13 Do you agree with our approach to determining notional gearing for each notional company?

We are not convinced of the need to reduce gearing levels by comparison with those applicable in RIIO-1 and that that is especially so in the light of the various measures proposed in the DD which result in a reduction in risk for the companies relative to the position in RIIO-1. We are particularly concerned that imposing a requirement to reduce gearing immediately (rather than requiring dividend restraint, at least in the first instance), gives rise to unnecessary equity issuance costs in the first year of the price control period when consumers are likely to be particularly impacted by the economic impact of Covid-19. We also think that, because of the ownership structure of the majority of the companies, subscription of additional equity is unlikely to incur issuance costs in most cases and that the allowance should be on a 'use it or lose it' basis (and with a clear explanation as to why costs have been incurred).

FQ14 Do you have any evidence that would suggest we should consider adjusting our notional company financing assumptions due to the impact of COVID-19?

No (see FQ12): in our view, all the market indications are that there is no need to make any adjustment to reflect the difficulties associated with COVID-19. In fact there is evidence that the reverse might be considered the case to (with no indication at all that there has been a change to the accepted view that utilities are attractive investments in times of uncertainty).

FQ15 Do you agree with our proposal to pursue Option A?

We agree with Ofgem that it is appropriate that companies should be largely, though not entirely, protected from tax risk so that they are incentivised to optimise their tax position. However we would have preferred a double lock or at least that tax outperformance under Option A should be shared with the consumer in the same way as totex outperformance.

FQ16 Do you agree with our proposals to roll forward capital allowance balances and to make allocation and allowance rates 'Variable Values' in the RIIO-2 PCFM?

We are not in a position to form a view at first hand but agree with the analysis set out in the DD.

FQ17 Do you agree with the proposed additional protections? In particular:

(a) Do you have any views on a materiality threshold for the tax reconciliation? Do you think the 'deadband' used in RIIO-1 is an appropriate threshold to use?

    Yes, we think a materiality threshold makes sense and that a 1% change in corporation tax rates (or 0.33% of opening base revenue allowances) remains appropriate;

(b) Do you have any views on the proposals to retain the Tax Trigger and Tax Clawback mechanisms from RIIO-1?

    We agree with both. We note that, because of the impact on the economy of COVID-19, it is quite likely that there will be changes to Corporation Tax rates during the control period and that these could be significant. In that context, the Tax Trigger appears to be set at an appropriate level. We consider the retention of the Tax Clawback an important basis for sharing risk with the consumer but question why Ofgem considers it appropriate to use different assumptions for the reduction in the gearing levels to be used for the gearing test (as set out in Table 37) from those used for the cost of equity calculations.

(c) *Do you have any views on the proposed process for the Tax Review?*

We can see no reason why it would not be possible to structure a process which is effective without being unnecessarily onerous for the companies (and, in any case, companies have – or should have – tax capability within their finance departments which could reasonably be expected to provide the information proposed);

(d) *Do you have any views on the proposed board assurance statement?*

We think the requirement makes sense and that it is appropriate it should be a licence requirement.

FQ18 Do you agree with our proposal to introduce a symmetrical RAMs mechanism as described above?

If there is to be a RAMS mechanism, we think it is appropriate that it be symmetrical and note that the inclusion of a RAMS mechanism is only one of several provisions which reduce the risk profile of the proposed settlement.

FQ19 Do you agree with our proposal to introduce a single threshold level of 300 basis points either side of the baseline allowed return on equity?

We consider 300bps the minimum appropriate threshold.

FQ20 Do you have any other comments on our proposals for RAMs in RIIO-2?

No.

FQ21 Do you agree with our proposal to implement CPIH inflation?

Yes, in the absence of any more appropriate alternative to RPI. We also agree that it should be introduced at the start of the control period.

FQ22 Do you agree with our proposals, including the policy alignment for GT and GD, and to recover backlog depreciation for GT RAV additions (2002 to 2021) over 20 years from the start of RIIO-2?

We think it is difficult, at this stage, to make a definitive determination as to whether or not the volume/stranding risk is significantly different between GT and GD. But, against that background, we consider that the proposed 45 year depreciation period is appropriate for both in RIIO-2 in the light of potentially shorter asset lives. We also support the recovery, over the 20 years from the start of RIIO-2, of depreciation on GT RAV additions over the past 20 years. We think that companies could have been more proactive in their use of depreciation rates to improve ratios but, since financeability assessments indicate that there is ample headroom in those ratios, we support the proposal to set them at levels which reflect expected asset lives.

FQ23 Do you agree with our proposed assumptions for capitalisation rates?

We take a similar view on capitalisation rates as we do of depreciation rates (see FQ22): we think that companies could have shown a greater willingness to use capitalisation rates to improve ratios but, in the light of the headroom in those ratios, accept the DD proposal to set them at levels which reflect the accounting distinction between capex and opex.

FQ24 For one or more of the aggregations of totex we display in Table 40, should we update rates ex-post to reflect reported outturn proportions for capex and opex?

The degree of uncertainty surrounding levels of totex (particularly capex) is such that this is an important issue. Against that background, we consider a good case can be made for updating capitalisation rates ex post.

FQ25 Do you agree with our proposal to use the closing RIIO-1 RAV balances as opening balances for RIIO-2?

Yes.

FQ26 Do you agree with our proposal to use estimated opening RIIO-2 balances until we have finalised the closing RIIO-1 balances?

Yes, it seems the most appropriate solution.

FQ27 Do you agree with the three categories of adjustment outlined below? PCFM adjustments between RIIO-1 and RIIO-2 such as opening RAV balance, depreciation allowance and opening capital allowance pool balance; impacts on RIIO-2 allowed revenues such as incentives that operate on a two year lagged basis; MODt value for final two years of RIIO-1.

We think that is probably an appropriate solution.

FQ28 Do you agree with our approach in using estimated values for closeout adjustments until we are able to close out the RIIO-1 price controls?

Yes.

FQ29 Do you agree that proceeds from the disposal of assets during RIIO-2 should be netted-off against totex for the year in which the proceeds occur?

Yes.

FQ30 Do you agree that we should carry out a review where an asset is transferred to a holding company and then subsequently sold to a third party?

Yes, this reflects practice in the water sector and is an important protection for consumers.

FQ31 Do you agree with our proposal to apply one interest rate to revisions to PCFM inputs and charging errors, based on a short-term cost of debt?

Yes, it seems a helpful simplification over the previous practice with no substantial downside.

FQ32 Do you agree with the margin-based approach, and the methodology used to calculate a margin of 110bps?

Yes.

FQ33 Do you have any reason why the marginal cost of capital for revisions to PCFM inputs and charging errors should remain distinct from each other, or why WACC may remain a more appropriate time value of money for a particular subset of prior year adjustments?

We think it is possible to construct arguments supportive of the use of the WACC but that, in the context of a rate which is to be applied to revisions and errors only, there is considerable merit in the simplicity of a single rate.

FQ34 Do you agree with our proposal to include forecasts for most PCFM variable values for the purposes of the AIP?

Yes – this seems a practical proposal.

FQ35 Considering re-openers as set out in these Draft Determinations, do you agree with our proposal to exclude them from any forecasting? If not, please submit specific examples or analysis of the potential materiality of actual spend versus initial allowances.

This is an important question in the context of the potential magnitude of reopeners during this control period. Because of the uncertainty surrounding them and their potential size, we agree that it would be better to exclude them from forecasts.

FQ36 Do you agree that additional reporting on executive pay/remuneration and dividend policies will help to improve the legitimacy and transparency of a company's performance under the price control?

Yes – and that legitimacy and transparency are important. We welcome the publication of such information in relation to a regulated public service entity – as Ofwat have determined in relation to water.

FQ37 Do you agree with the proposed definition of Base Revenue?

Yes.

FQ38 Do you agree with the proposal to fix the values used for DDI caps and collars at final determinations?

Yes.

2. Electricity System Operator

ESOQ1. Do you agree with our proposal to incorporate EMR into the ESO's wider outputs incentives scheme?

Yes, these activities are interrelated and should be included for consistency of incentives.

ESOQ2. Do you agree that it is appropriate to maintain the ring-fence between the EMR DB and ESO in its current form?

Yes, and that Ofgem should keep the need for this under review.

ESOQ3. Do you agree we should regulate system restoration costs in a consistent manner to other external balancing costs?

Yes, black start costs should be included in the overall balancing incentive.

ESOQ4. Do you agree with our approach to setting up-front performance expectations?

Yes, in principle, setting ex-ante expectations for good and poor performance will provide a clearer incentive. However, the setting of targets should incentivise both the shorter and longer term impacts that the ESO has in its role e.g. shorter term benefits from efficient despatch of balancing services, and longer term whole system benefits from improved system planning, and improvements to balancing market designs.

ESOQ5. Do you agree that a financial reward or penalty should be determined every two-years, to align with the period over which we set expectations, costs, and outputs?

Yes, and agree that revenue should not be banked during the period and this may influence the overall performance over the period. Ofgem may also want to consider whether a longer-term incentive design can be developed to match incentives with ESO actions that should bring whole system and NetZero benefits well into the future.

ESOQ6. Do you agree with our proposed approach to within-scheme feedback, including the timings and approach to performance panel sessions?

Yes, we agree with the proposed timings of feedback and reports by the performance panel during each 2-year period. We agree that single scores with a clear narrative should provide predictability on performance.

ESOQ7. Do you agree with our proposed evaluation criteria for RIIO-2?

Yes, we agree that value for money should be added to the other evaluation criteria.

ESOQ8. Do you agree with our proposals on the incentive scheme value?

We are keen to see the ESO proactively promoting ambitious initiatives that lead to wider system benefits. We agree that loss aversion may be a disincentive for the ESO to take risks but the proposed reduction in the maximum penalty should serve to address this concern.

We note that this leads to a potential annual RORE range of 1 to 16% which appears an appropriate rate of return range to incentivise ambition in an entity with a risk profile such as that of the ESO. However, the proposed 'additional funding' of £1.9m pa would increase the upside of that range to the point that we consider particularly difficult to justify in the current economic climate unless special provisions are made relating to it. In our view, the purpose of any such 'additional funding' funding should be defined – for example, for the purpose of covering the cost of the guarantee by National Grid of the ESO's working capital facility, and should be provided on a 'use it or lose it' basis.

Outputs consultation questions

ESOQ9. Do you think that our proposals will capture the full scope of minimum obligations/standards associated with the ESO's Business Plan activities?

The proposed additional obligations being placed on the ESO to promote competition, coordinate network planning and operation, coordinate with TOs and DNOs, facilitate an efficient transition to a zero carbon energy system, and modernise energy data, provide a welcome clarification to the ESO's role. This expansion of responsibilities clarifies the ESO's role in enabling NetZero and Whole System outcomes and benefits.

However, the ESO is primarily a delivery body and will not be able to deliver these responsibilities without clear direction and coordinated decisions from Ofgem. We suggest that Ofgem sets out in the final determination how it will undertake its own leadership role with respect to these activities.

ESOQ10. Do you agree with our proposed changes to the ESO Roles Framework guidance?

Yes, the proposed approach is simpler and matches the key activities performed by the ESO and their impacts in different timescales.

ESOQ11. Do you agree with our grading of the ESO's RIIO-2 aims and Delivery Schedule for 2021-23?

Yes, we agree with the gradings Ofgem has applied to the ESO ambition and delivery plans. In our January report we welcomed the ESO's ambition but had concerns about the ESO's ability to deliver planned initiatives across roles 1 to 3.

ESOQ12. What are the priorities for the ESO to achieve by March 2023 to exceed your expectations?

To exceed expectations we expect the ESO to demonstrate that it has delivered or made substantial progress towards new initiatives that will deliver clean, affordable and secure energy supplies over the short and long term. To exceed expectations, we would expect these initiatives to demonstrate ambition and measurable delivery over and above baseline performance expectations.

ESOQ13. Do you agree that these are the right performance metrics to assess ESO's performance?

Yes, the streamlined list of performance metrics appears appropriate. We note that the performance measures set out in table 15 are operational in nature e.g. comparison of balancing costs with historical average, demand forecasts, frequency excursions, and % of competitive procurement for balancing services. They will not necessarily measure the progress towards strategic objectives of gaining Whole System or NetZero benefits.

ESOQ14. Do you agree that these benchmarks are sufficiently challenging?

Yes, these benchmarks appear appropriate for the first 2-year period.

ESOQ15. Do you have any comments on the revised methodologies we have proposed (in Appendix 3) for assessing ESO's performance on balancing costs and forecasting?

Balancing costs are increasing year on year with the growth of renewables and the ESO has a critical role in minimising these costs through its market design, network planning as well as day to day operation. We are keen to see that the ESO is incentivised to take all possible steps to minimise short and long-term balancing costs.

Ofgem is consulting on changing its methodology to calculate a balancing cost benchmark, currently based on 5-year historical averages. It is proposed to make an adjustment to reflect the additional balancing costs caused by increased (and atypical) wind generation. We would like any balancing cost benchmark adjustments to be kept to a minimum so as to maintain an incentive on the ESO to reduce actual balancing costs rather than an adjusted figure. If an adjustment is applied, it should be simple and transparent and not dilute the incentive on the ESO to take action.

We are concerned that the ESO performance measures are overly focused on short term performance and not sufficiently taking account of opportunities for future balancing cost optimisation through, for example, future use of distributed energy resources or storage.

We would like to see consideration given to the development of a methodology to determine 'perfect foresight' balancing cost benchmarks, perhaps similar to the proposed approach for assessing NGGT shrinkage performance. This could provide a better comparator than adjusted historical data.

ESOQ16. Do you agree with our proposals for measuring stakeholder satisfaction?

Yes, an independent survey with the approach approved by Ofgem is welcome. We agree that this should include code performance and connection performance.

ESOQ17. Do you agree with proposed approach to tracking plan benefits?

Yes, the ESO business plan promised strategic goals of a) some £2 billion of net (whole system) benefits to consumers over the RIIO-2 period, b) carbon-free operation by 2025, alongside its obligations for security of supply. We think progress towards both carbon free operation and whole system benefits should be closely tracked.

ESOQ18. Do you agree with our suggested areas for regularly reported evidence?

We agree that evidence that demonstrates progress toward the strategic goals and longer term benefits should be regularly reported. The performance measures identified individually appear appropriate, but some are more operational in nature (for example, the number of voltage excursions), and others are more strategic (for example future savings from operability solutions).

We would suggest that performance measures and reporting requirements are developed further over time to ensure that they enable the strategic goals of carbon free operation and net benefits to consumers to be assessed. These high level performance measures could be supported by secondary measures that demonstrate how the ESO's progress in its individual roles is contributing to these strategic goals.

<u>Costs consultation questions</u>

ESOQ19. Do you agree with our overall approach to cost regulation for the ESO?

We think the ESO price control must strike a balance between incentivising the ESO to deliver the whole system and NetZero benefits, while also ensuring that the ESO is incentivised to avoid wasteful expenditure. We don't think the ESO can be given a blank cheque.

We agree the cost pass through approach, with the performance incentive regime including a value for money element, which provides for the ESO to justify any under/over-spend.

We agree that an ex-post disallowance backstop to disallow demonstrably wasteful expenditure is needed. We note that the ESO price control includes a two year plan period plus uncertainty mechanisms which will allow the ESO to gain ex-ante agreement of proposed expenditure, thereby reducing the likelihood of ex-post disallowance.

ESOQ20. Do you agree with our assessment of the ESO's totex?

Yes we agree with the approach taken by Ofgem in identifying efficiency savings, and in making early stage IT projects subject to an uncertainty mechanism.

ESOQ21. Do you agree with the method we have taken to set each role-specific cost benchmark, including the proportions of capex and business support allocated to each role?

Yes, it seems an appropriate approach.

ESOQ22. Do you agree with our proposed approach to updating the internal costs benchmark within the price control?

Yes, it appears to be an appropriate and practical approach.

ESOQ23. Are our disallowance proposals proportionate and do they provide the ESO with sufficient ex ante certainty?

It is important that the ESO should have sufficient ex-ante certainty not to deter expenditure in potentially high-risk IT projects. We think that the proposed uncertainty mechanisms should enable these projects to be approved only once they have a well-defined scope, cost and risk margin, thereby giving the ESO certainty that these projects will be funded.

Nevertheless, we think it is important that the disallowance terms remain to act as a deterrent to wasteful expenditure given the ESO has a cost pass through regulatory regime. Without such a deterrent the ESO may seek to inefficiently increase the RAV to enhance returns.

We think that the conditions that Ofgem have defined to give comfort to the ESO about when disallowance can be applied are appropriate. We note that the Ofgem proposal is that up to 10% of the ESO's RAV may be disallowed in any one year, resulting in any potential disallowance being capped at c£12m, which represents around 5% of ESO annual revenue. Given the flexibility provided by the overall totex allowance, the project specific uncertainty mechanisms, and plan revision after two years, we think a limited disallowance is a proportionate approach. However, we would suggest that innovation expenditure should also be excluded from the risk of disallowance so as not to deter potential high-risk innovation projects from proceeding.

ESOQ24. Do our proposed changes to the reporting of changes to the ESO's shared services costs offer a sufficient level of consumer protection?

Yes, we would ask that ESO shared service costs and charging arrangements are publicly reported in a sufficient level of detail to allow effective scrutiny and to give confidence to industry participants.

<u>Finance consultation questions</u>

ESOQ25. Is there a better method for setting a debt allowance for the ESO?

We think the methodology used for setting the debt allowance is appropriate, reflecting the fact that the ESO will not need such long-term debt as the network companies. We agree that the ESO's proposed 25bps addition to debt indices is unnecessary in the context of the low risk profile of the ESO under the proposed regime.

ESOQ26. Do you have evidence to suggest the equity allowance should be higher or lower for the ESO?

We consider the cost of equity allowance should reflect the risks to which the ESO is exposed and that these are low, because:

- The incentive regime is a smaller proportion of RAV than it was in RIIO-1 with only £6m of downside per annum, compared to £30m pa during RIIO-1. It is also asymmetric with a much higher range on the upside. Black start cost disallowance risk has been removed.
- The ESO benefits from a cost pass through policy and is therefore not exposed to cost overruns as in RIIO-1.
- The uncertainty regime for major IT projects, under which such projects are agreed on a project by project ex-ante basis, greatly reduces the risk of ex-post disallowance.
- Potential ex-post totex disallowance will only be applied to wasteful internal expenditure and is in any case capped at 10% of annual totex, thereby minimising the chance that it will be applied.
- The ESO receives a specific allowance to fund Working Capital Facility costs; the ESO has an adaptive price control regime, with plans being revised every 2 years, further reducing risk.
- Recent evidence indicates that the regulatory regime is perceived to have mitigated the ESO's exposure both to the 9th August 2019 blackout events, and the Covid pandemic.

Based on the above, we think the 5.28% cost of equity allowance which is proposed in the DD (and which is significantly higher than that proposed for other network companies) is at the upper end of the range that might be deemed appropriate.

We think it important that the return on equity allowance is such that the ESO is incentivised to promote ambitious investments that have wide system benefits but that an excessive RAV-based equity return risks incentivising the ESO to invest in assets, potentially at the expense of better opex-based solutions.

Given this is the first ESO price control, we think that the proposed higher cost of equity is acceptable if the proposed £1.9 million of additional funding is provided on a transparent, pass through, 'use it or lose it' basis for defined expenditure.

ESOQ27. Do you agree that our proposals for additional funding reflect the ESO's role during RIIO-2?

Given the way the ESO price control has been structured to minimise risks, including revenue collection, performance, cost, operations, reputational risk, legal risk and regulatory risk, and also to provide a high equity return, we don't think that any additional funding is required. The purpose of any such funding should be clearly identified – for example, to cover the cost of National Grid's potential guarantee of the working facility which the ESO will need, and we consider it should be provided on a pass through, 'use it or lose it' basis.

ESOQ28. Do you have a strong view on how the ESO should recover its costs for a WCF or whether the implied allowance is sufficiently accurate for the full RIIO-2 period?

We think the ESO should be able to recover the costs it will incur and setting up and paying the on-going interest and other costs of a working capital facility of an appropriate size. To the extent that it also incurs guarantee costs with National Grid, we consider those should be funded on a transparent pass through basis.

ESOQ29. Do you agree that our proposed funding and financing arrangements allow the ESO to efficiently finance its activities?

Based on the proposed cost of capital allowances (and without any additional funding) we think the ESO's plan is financeable on both a notional and actual basis without mitigating actions.

<u>Innovation consultation questions</u>

ESOQ30. Do you agree with the level of proposed NIA funding for ESO? If not please outline why.

Yes we agree with this level of funding which provided the ESO with all the funding it has requested in its 2 year plan. We also agree that the funding should be conditional on the introduction of an improved industry-led reporting framework.

We think that the ESO has a key role to play in gaining innovation benefits, including from emerging technologies. Transformational projects are likely to need a five year time horizon. It will be important that innovation funding for later years is not delayed by the regulatory approval process for the next ESO RIIO-2 business plan. We suggest that Ofgem provides a contingent commitment to the ESO innovation expenditure for the last 3 years subject to subsequent Ofgem approvals.

ESOQ31. Do you agree that ESO's NIA funding should be subject to the condition that all projects must involve partnership with other network companies, third party innovators and/or academics?

We agree that the ESO could valuably develop partnerships with academia and wider industry, but do not see why this should be constrained by requiring partnerships with network companies.

<u>Uncertainty consultation questions</u>

ESOQ32. Do you believe our price control design is sufficiently flexible to account for uncertainty? Are there any relevant foreseeable future uncertainties which we have not identified here?

Yes, Ofgem have adopted a flexible approach without a totex incentive, which is effectively cost pass through of expenditure. This approach, together with the shorter two-year plan review period should provide flexibility to adapt to future uncertainties.

ESOQ33. Do you have any views on whether we should introduce a different funding approach or uncertainty mechanism to account for the risk of material changes to the ESO's revenue collection role? Do you have any views on how this should be designed?

We think that the ESO may need an uncertainty mechanism that addresses revenue collection risks if these are outside its control and are not mitigated by other industry rules e.g. for credit guarantees. Any lowering of the ESO's risk profile because of the introduction of such a mechanism should, in our view, give rise to lower cost of capital allowances.

<u>Other areas consultation questions</u>

ESOQ34. Do you agree with our assessment that the current approach, with the ESO's IT provided by National Grid Group is not appropriate for the future? Have we identified the correct concerns with the current model?

Yes, as highlighted in our January report we were concerned both that IT costs provided by National Grid Group may be more costly than necessary and presented a direct conflict of interest. We agree with your concerns and that the ESO should take full control of its IT delivery.

ESOQ35. Do you agree that the ESO needs full control of its IT provision? Are there other options that you think are preferable?

Yes, we think the ESO should be able to operate as a fully independent company that can deliver major IT projects that are necessary.

ESOQ36. Do you have a view on the proposed timing of implementing IT autonomy?

This should take place when the ESO has shown that it has a plan and capabilities to manage these new IT responsibilities. In particular we think the ESO will need to enhance their capability to govern and manage complex IT portfolios. It will be important for the ESO to have the capability to procure and manage a complex portfolio of IT projects. It may need to transfer such resources from National Grid Group.

ESOQ37. Do you agree with our position that the ESO should recover its internal costs based on actual spend within year? Do you believe this change would create any new information/forecasting needs to allow industry to anticipate and manage this?

We agree that an annual cost pass through of internal costs is appropriate.

ESOQ38. Do you have views on whether the NIA and other ESO pass-through items should be recovered via TNUOS or BSUOS?

No, except that all cost recovery should be transparent.

ESOQ39. Where or how can the ESO's existing reporting requirements be streamlined?

We have no comment to make on streamlining of reporting but would request that information provided allows consistent and transparent reporting of ESO expenditure and returns, and benefits to consumers.

ESOQ40. Do the proposed timings for the BP2 process provide sufficient time for the ESO to develop and refine a robust plan, stakeholders to contribute to this and Ofgem to undertake the necessary assessment and decision making?

The timetable seems appropriate, with a draft ESO plan being produced in April 2022 and final plan by August 2022. The Ofgem draft determination is due in November 2022 with a final determination in March 2023 for implementation from April 2023. This timetable should enable effective stakeholder feedback and ensure the plan is as up to date as possible in a changing industry landscape.

3. NARM

In our January report to Ofgem, we recognised that the NARM monetised risk metric is a key determinant of the benefits calculation in the CBAs, but were concerned that any shortcomings or data immaturity in this metric could both prejudice upfront decision-making, and reduce certainty in the measurement of actual risk reduction benefits delivered to customers.

We noted that there appeared to have been significant volatility in the monetised risk calculations between different versions of the plans and asked that we would like to see NARM's evidence corroborated by other data such as details of actual asset condition.

We remain of the view that the NARM data and methodology is relatively immature and cannot be solely relied upon for decision making. We support further development as described in our answers below.

NARMQ1. Do you agree with our proposals on the scope of work within each of the NARM Funding Categories and on the associated funding arrangements?

We agree with Ofgem's proposals on the NARM funding categories and funding arrangements. NARM is an especially important output for providing customers with assurance that network risks are being efficiently managed and, while we understand Ofgem's decision not to extend the measure immediately to cover non-lead assets, we would encourage it to be progressed during the RIIO-2 period.

NARMQ2. Do you agree the funding adjustment principles and our proposals for applying funding adjustments?

In our January report, we expressed some concerns about the potential for an unadjusted NARM output measure to lead to unexpected windfall gains to companies, and to higher costs for customers over the longer term. We agree with Ofgem's proposals to adjust NARM funding, to take account of outturn NARM unit costs, and consider that it addresses our earlier concerns. In determining the calibration of the mathematical functions used to adjust allowances in line with outturn costs, we support Ofgem in establishing a balance between returning savings to customers and maintaining an incentive on companies to innovate and out-perform.

NARMQ3. Do you agree with our proposed approaches to calculating funding adjustments and to application of penalties?

Yes.

NARMQ4. Do you agree with our proposals in regard to requirements for justification cases?

We agree with Ofgem's proposals and would encourage Ofgem to consider ahead of time how the justification process can be both streamlined and provide clear assessment criteria so that customers gain the benefits from genuinely justified projects. We support the idea in 4.48 to develop guidance in relation to the nature and quality of engineering and other evidence required for any justification.

4. Electricity Transmission sector

Outputs

Energy Not Supplied incentive – We think this incentive should be designed to ensure that customers continue to enjoy high levels of reliability. While noting that ENS excludes a number of events out of the companies' control, we agree with the proposed Ofgem approach of taking account of reliability performance since 2000 (with a weighting for the more recent RIIO-1 period) to produce a historic average on which future targets can be reliably based.

Quality of connections incentive - We agree that the quality of connections offered by the TOs is an important customer output and that this should be incentivised through an ODI-F. We think new connections should be both delivered in a timely way and deliver value for money. Connection service quality should be measured across the whole connection process i.e. from the application for connection through to the commissioning of the connection assets.

ETQ1. Do you agree with our proposals to switch off the incentive in year one of RIIO-ET2 in order to pilot the Quality of Connections survey and develop the baseline targets?

ETQ2. Do you have views on the common milestones, target audience and question of overall satisfaction for the Quality of Connections survey incentive provided in Appendix 2?

We agree that it will be important to gather data in the first year of ET2 so that a baseline can be established for the remainder of RIIO-2. On the survey proposals, the approach set out appears to cover the appropriate milestones from initial engagement through to connection delivery for all relevant customers. We agree with the proposal for a common question on overall satisfaction and that this should be the basis of the reward or penalty. However, we think there is scope for a wider range of common questions that seek customers' feedback on the time, cost and quality of connections and that these should also be reported to Ofgem. These should include questions on:

- Compliance with required connection offer/delivery timetables
- Whether TOs have offered the best technical design to meet customer requirements
- The value for money of the proposed solution
- An open question following the satisfaction question to allow customers to articulate in their own words why companies have performed particularly well or badly.

This wider range of questions in common would allow for a more in-depth understanding of how TOs are serving customers in this important area, and for those results to be comparable across all three companies. We agree that it would still then be appropriate for TOs to be able to add their own bespoke questions, and that the User Groups can play a role in assuring that these questions are appropriate.

The surveys should also capture the performance of the ESO in the connection process.

We also suggest that Ofgem reverts to its original plan of requiring TOs to use a single, independent research agency to manage the survey across all three TOs. A single provider would help ensure greater consistency in analysing and reporting results, as well as in survey design, which will support comparability of the results.

Stakeholder Survey for new transmission projects – ODI-R: We agree with Ofgem's view that this should be undertaken by the companies and regularly published. However, we would suggest that this should be included as a licence condition so that Ofgem has the ability to enforce if it is not completed. We have identified elsewhere the general risk that reputational outputs may not be delivered as companies seek to meet their efficiency targets.

Timely Connections incentive: We agree that a financial (penalty-only) incentive for Timely Connections of -0.5% of totex is appropriate.

Network asset risk metric - We agree that NARM is a key metric for the price control that ensures that companies are funded to appropriately to maintain resilient assets. We expect Ofgem to provide sufficient funding, and companies to take the necessary interventions, to ensure that network asset risk is kept within reasonable bounds that is to say, broadly constant across the RIIO-2 period. We welcome that an incentive regime is to be applied to the measurement and delivery of NARMs and agree that the Ofgem proposals for its design are appropriate.

We have set out our views on the application of the NARMs in the NARM specific questions elsewhere in our reply. We would specifically highlight the need to ensure that NARM Baseline Network Risk Outputs are measured and targeted such that customers enjoy the benefits of the allowance given to the companies for investments in asset health. In this respect, we are concerned that the DD determination for proposed risk outputs for NGET appears to show a low risk output level. We address this issue further in our NGET and NARM comments.

ETQ3. Do you think there are any additional KPIs that have not been included in the final NAP which would support monitoring of performance in adherence to the NAP and/or add transparency of the outage planning, management and implementation process for relevant stakeholders?

We consider that the proposed NAP and KPIs are appropriate and will promote transparency. We agree that this should remain a licence obligation.

ETQ4. Do you agree with our proposed LPD mechanisms and do you agree with the criterion that we are proposing to use for our LPD mechanisms?

Yes, we agree with the LPD approach which will incentivise time, cost, and quality (including mitigation of consumer detriment) of large project delivery. The proposals to introduce a) annual reprofiling of allowances to better meet actual expenditure, b) making payments against delivery milestones, and c) including a late delivery/liquidated damages charge, should ensure that customers benefit from typical commercial arrangements for the delivery of such projects.

ETQ5. What are your views on applying our LPD mechanisms to some or all of the projects identified at paragraph 2.74?

Yes, we agree that the LPD mechanisms should apply to all these listed projects, any other projects (LOTI) that exceed £100m in value, and to RIIO-1 Strategic Wider Works projects.

ETQ6. What are your views on our consultation position for the three electricity TOs' EAP proposals in RIIO-2 as set out in this document?

We have commented on the EAP and AER framework in the context of the core document. We agree with Ofgem's proposal to accept the majority of EAP commitments, together with the additional funding of c£40m above existing RIIO-1 levels.

We also agree with the proposal for an ODI(R) in respect of BCF reduction across the transmission sector and support the need to require SPT to provide an SBT and a target for RIIO(2). We support Ofgem's requirement for further evidence of interventions relating to emissions from building energy use given the scale of the proposed funding requests. In relation to carbon management we note (and welcome) that Ofgem is 'encouraging' SHET and SPT to strengthen their ambitions by setting targets for reduction of embedded carbon during course of RIIO2. As noted elsewhere we have a concern that companies will be tempted to scale back ambition in relation to outputs so it will be important in planning for RIIO(3) for Ofgem to take note of the extent to which companies have responded to this kind of reputational exhortation.

Insulation and Interruption Gases (IIG) leakage incentive – We welcome the steps being taken to address SF6 leakage. We agree with Ofgem's approach of using a baseline target based on the average leakage rate in years 2013 to 20, with a 15% improvement factor during RIIO-2 as the output parameters for the ODI(F) incentive.

ETQ7. What are your views on our consultation position for setting the expenditure cap for visual amenity mitigation projects in RIIO-2?

We agree that this needs to balance affordability and visual amenity. The proposal for £465m cap should deliver significant benefits while minimising the impact on electricity costs for consumers. We note that this is proportionately higher than the £500m allowance for the 8 year RIIO-1 control, and that additional future visual amenity benefits may also be realised for LOTI projects and other expenditure approved under uncertainty mechanisms. Expenditure and benefits for visual amenity should be reported by companies during RIIO-2.

ETQ8. Do you have any views on our outputs that have not been covered through any of the specific consultation questions set out elsewhere in this chapter? If so, please set them out, making clear which output you are referring to.

We have concerns that the outputs for network asset health, as measured by NARMs may not be sufficiently well defined or targeted. We address these further in our comments on the NARM specific questions.

ETQ9. Do you have any views on our overall approach to setting totex allowances?

We agree with the cost assessment approach used for setting totex allowances. We agree that there are difficulties in comparing between transmission companies due to their different size and scale, and the shortage of comparable benchmarking data.

We welcome that Ofgem has considered the companies' historical incurred actual costs in assessing efficiency. In our January report to Ofgem, we also highlighted where companies were apparently seeking expenditure above their historic run-rates of efficient expenditure, or above benchmarks of unit costs.

We think the RIIO-1 historic run rates of expenditure (excluding load-related capex) demonstrate the efficient level of expenditure needed by the companies to deliver safe, reliable and environmentally sustainable networks and maintain good asset health. Equivalent future levels of expenditure should decrease as ongoing efficiencies and innovation benefits are realised.

<u>Capex</u>

For capital expenditure, we agree with the approach that has been adopted of first assessing the needs case and then the efficient costs. We think the EJP assessment framework is an effective way of assessing the need for load/non-load investment, the options and efficiency of interventions to meet the need case, and the confidence in the timing, costs and outputs delivered. We welcome the detailed reviews of expenditure that have been performed.

For the assessment of capex costs, we note that Ofgem has used an independent benchmark of unit costs for each type of asset, based on the lower of the historic and forecast average unit costs for each asset type across the three TOs. The proposed allowance uses the lower of the network company's proposed costs and Ofgem's benchmark. Adjustments are made to separate out risk and contingency costs in company forecasts.

The identification of an average historic unit cost benchmark (which already reflects efficiency savings and the application of contingency costs) should provide a good basis for unit cost benchmarking. While we note that the inclusion of forecast unit costs alongside historic will give a longer time series, we are concerned that forecast unit costs may be less certain and may be overestimated, leading to an increase in the average cost benchmark. Given RPE indexation will apply to future baseline unit costs, we suggest Ofgem should consider whether to rely only on evidence from historic unit cost benchmarking in determining future unit cost allowances.

To ensure that capex projects with an agreed needs case are delivered and can benefit consumers, we agree that schemes and volumes should be listed in the price control and identified as PCDs or uncertainty mechanisms wherever practicable.

We agree with the proposed approach for ensuring that projects spanning price controls receive allowances based on actual expenditure during each control.

<u>Non-operational capex</u> - We agree with the approach that has been used in assessing non-operational capex, across property, equipment, vehicles, and IT&T.

<u>Opex</u> – We agree with the approach that has been used in assessing network operating costs and indirect opex (Business Support Costs and Closely Associated Indirects). We support the use of historic data to avoid undue dependency on network company forecasts.

<u>Ongoing efficiency</u> – We note that the companies have demonstrated a strong track record in RIIO-1 of making average efficiency improvements of more than 2% pa. All companies have identified plans for some efficiency savings during RIIO-2 and associated innovation investments. We think the proposals for a 1.2% challenge for capex and 1.4% for opex are appropriate.

Uncertainty mechanisms

Overall, we welcome the approach that Ofgem has taken to uncertainty mechanisms which appear to strike a good balance between ensuring that baseline allowances only include necessary and efficient investment, and enabling any additional expenditure to benefit consumers to be funded. The mechanisms should also provide additional revenue certainty to the companies.

We generally agree with the list of UMs in Table 17. We consider the cross sector pass-through, indexation, and re-opener mechanisms are appropriate. For ET-specific, we agree with the proposed approach. We have addressed bespoke UMs in our answers for each company.

<u>Generation and demand connections</u> – we agree it is important that companies are funded to provide timely and efficient connections to customers, but that there will be uncertainty about the timing, capacity and costs involved. The volume drivers proposed by Ofgem should address the timing uncertainty, but we note that the project costs may vary significantly depending on factors such as cable/overhead line requirements, making the costs uncertain.

It will be important that the volume driver mechanism is designed to both allow the companies to recover efficient costs, and to ensure that customers do not overpay because the mechanism is set at too high a level. We agree that volume drivers should be modelled on a combination of capacity and proportions of linear assets (overhead line, cable), and that the baseline allowance is adjusted for upwards or downwards outturns of the capacity and linear asset combinations. We agree that projects between £25m and £75m which significantly exceed volume driver allowances should be covered by the MSIP reopener. We think this is an appropriate balance between providing automatic funding through a volume driver and ensuring efficiency through additional scrutiny.

Reactors – we note that a volume driver is also proposed for reactors. We think the baseline allowance should also be adjusted for upwards and downwards outturns depending on numbers of reactor installations and reactor capacity. However, the need case for reactors will be driven by the ESO, and we would wish to ensure that requirements are defined after consideration of whether there are better non-network solutions.

We agree with the design parameters for the reopeners, with an annual reopener window that can be triggered by Ofgem or companies, together with a materiality threshold. A 1% of revenue materiality threshold seems appropriate.

We agree with the proposed opex (NOC/CAI) volume driver to reflect the addition of new assets through uncertainty mechanisms.

It will be important for Ofgem to establish the necessary resources and processes to ensure that projects can be assessed and determined in a timely way, including public consultations. We note that recent transmission price controls have included successful arrangements for in-flight approval and assessment of individual projects, including those for Strategic Wider Works and Transmission Investment for Renewable Generation (TIRG) projects in Scotland, and suggest that there may be useful experience to be gained from these processes.

ETQ10. Do you agree with our proposed eligibility criteria for the LOTI re-opener and do you agree with the assessment stages, and their associated timings?

We agree with the proposed LOTI approach for Ofgem to scrutinise the costs and benefits of projects exceeding £100m more closely. However, we are concerned that companies may seek to divide network investments into individual projects below £100m to avoid scrutiny, so would ask Ofgem to ensure that they are able to assess all projects that should fall into the £100m category.

We think that Ofgem's proposed process and timing for assessments of neesd case and efficient costs are appropriate and should enable investment in large projects which is both timely and efficient. We welcome the fact that the process has been designed so that it is compatible with competition in transmission when it is possible for this to be introduced.

ETQ11. Do you agree with our proposed definition of PCF for RIIO-2, and the areas of work that we intend that definition to cover?

We agree with the definition of PCF and that baseline PCF should be provided to companies to proceed with projects identified in the NOA and supported by engineering justifications. We agree that these allowances should be linked to PCDs for individual projects so that unused allowances may be returned to customers.

ETQ12. Do you agree with our proposal to assess PCF costs as part of RIIO-2 Closeout, following the principles set out in Chapter 4?

We agree that companies should be able to proceed with efficient pre-construction works on additional projects that emerge during the price control. Ofgem's proposal to assess these costs as part of Closeout (allowing logging up of efficient costs against pre-defined conditions) should enable this expenditure to proceed and protect customers from inefficient expenditure on projects that are not required. While the 2.5% allowance for project development costs appears appropriate based on recent projects, we note the list includes an NGET project which had a seemingly high 19% PCF.

ETQ13. Do you agree with our proposed scope of, associated eligibility criteria for, and timing of the submission window under the MSIP re-opener?

We agree that this mechanism should be used to assess expenditure for projects that fit into the categories of a) outlier connections, b) increasing boundary capacity, and c) externally-driven works.

We think this approach is important to ensure that the needs case assessment fully considers the options for the optimum economic solution, including non-network solutions. This is particularly important for consideration of boundary investments and may help to realise the significant savings that are available to customers. We think this is consistent with gaining the smart system benefits recognised both by Government and by the ESO in its business plan. MSIP and Ofgem's oversight can play a key role in ensuring that these whole system savings can be realised.

We agree that one submission window should be appropriate for such investments, and January 2021 appears suitable.

5. NGET

In our January report to Ofgem, we expressed our concerns that NGET totex was poorly justified and forecast expenditure appeared significantly higher than necessary. We identified that:

- EJPs and CBAs were weak and did not justify the proposed expenditure
- NLRE volumes and unit costs were significantly higher than RIIO-1 historic run rates and increases were unjustified
- LRE expenditure was uncertain and should be subject to uncertainty mechanisms
- Increased opex and non-operational capex expenditure was not justified.

As such, we strongly support the evidence-based approach that Ofgem has taken in reducing the baseline expenditure for NGET, while retaining the option for expenditure to be added if either further evidence is provided by final determination, or through the use of uncertainty mechanisms during the price control.

Overall, we agree with the approach to outputs for NGET. We have provided our comments on common outputs elsewhere in our response and address the specific NGET outputs in this section.

Outputs

Q1. Do you agree that an Environmental Scorecard ODI-F would be in the interests of existing and future consumers?

Yes, we agree.

Q2. Do you support our proposed changes to NGET's Environmental Scorecard proposal?

In our January report we noted that the rewards associated with this ODI were relatively modest but expressed concerns about the cost of delivery of some of the environmental commitments. However, against a background where the costs of the outputs have been scrutinised and in some cases disallowed or reduced we do consider that the proposed environmental scorecard, with the various changes proposed by Ofgem will incentivise delivery (and penalise non-delivery) of benefits in the interests of existing and future consumers.

Q3. Do you agree with our proposal to reject the Accelerating Low Carbon Connections ODI-F?

We agree that this should be rejected. We think that the Quality of Connections Incentive should drive performance in this area.

Q4. Do you agree with our consultation position to reject the 'RIIO-T2 System Outage Management Proposals to Reduce Constraint Costs'?

We agree that constraint costs should be optimised through improved outage management, but this should be business as usual and be applied as a licence obligation on the ESO and TOs. We agree that any additional incentive mechanism should only be established once it is clear that it can deliver additional benefits over those already available.

Q5. Do you agree with our proposals on the PCDs? If no, please outline why.

We agree with Ofgem's proposals for accepting and rejecting PCDs based on the evidence provided.

Q6. Do you agree with our proposed approach to facilitating NGET's transition to an EV fleet?

While we welcome NGETs proposals to transition to an EV fleet, we think further work is needed to assess if this may be business as usual given this choice should result in lower costs for the business over time. We question why additional expenditure should be included in the NGET price control for charging infrastructure, given this may crowd out competition for these connections.

Q7. Do you agree that there is a need for a SF6 asset intervention PCD, and do you agree with our rationale for making this mechanism a PCD rather than a UM?

We welcome NGET's proposals for reducing SF6 emissions over and above the IIG incentive but are concerned that the mechanism is not sufficiently well defined in terms of forecast modelling, interventions and costs and how it interacts with IIG incentive.

A PCD approach may be appropriate if output targets (and expenditure) can be agreed that are clearly additional to the current baseline expenditure and IIG incentives, also considering if it may be appropriate to increase the IIGS target or, as indicated, even not apply the ODI(F) .

Qs 8. Do you agree with our proposals on the CVPs? If no, please outline why.

We agree with Ofgem's proposals to reject the majority of NGET's CVPs. In our January report we noted that several NGET's CVP proposals are what we would expect to be included as business as usual or are addressed elsewhere in regulatory arrangements. However, we did recognise potential merit in the proposal relating to harmonic filtering and note that the DD is ambivalent as to whether this might deliver value and that NGET's proposal for a bespoke UM has been accepted as a common ET UM. Subject to eligibility we think the position on this CVP should potentially be reviewed.

Q9. Do you agree with our consultation position to accept (subject to eligibility) NGET's caring for the natural environment CVP? Do you agree with our proposal to re-quantify the value of the CVP?

We agree that this CVP could add value subject to outputs and targets being defined to ensure the delivery of additional benefits.

Q10. Do you agree with our proposal to reject NGET's SO:TO optimisation CVP?

Yes, we agree. We think that this is potentially duplicating and undermining other existing obligations and incentives for constraint cost reduction.

Totex

Overall, we agree with Ofgem's proposals for cost and volume reductions based on the evidence provided. We agree that the level of information provided, and justification of expenditure in the NGET plan was poor.

We welcome that Ofgem's approach has been to assess in detail the evidence provided by the companies to justify expenditure, and that there is an opportunity for companies and Ofgem to consider further evidence before final determinations.

Q11. Do you agree with our proposed allowances in relation to load related capex? If not, please outline why.

We note that NGET requested £1116m of LRE capex and that Ofgem has removed £225m, with £118m relating to rejected schemes and £107m relating to cost reduction. We agree with the methodology used and with the low degree of confidence attributed to a significant proportion of these costs.

Given the lack of confidence in these costs and volumes, we think it is important that the regime for load related expenditure should reflect this uncertainty in order to ensure that the baseline expenditure is not set at too high a level, while also ensuring that all necessary expenditure may proceed. We think that as much as possible of LRE should be subject to PCDs or UMs.

Q12. Do you agree with our proposed allowances in relation to non-load related capex? If not, please outline why.

We note that Ofgem has reduced NGET's NLRE bid from £2651m to £744m, which includes a £556m true up and clawback from RIIO-1 to RIIO2. Ofgem has highlighted the weaknesses in need case evidence and the lower confidence in NLRE with which we would agree. Overall, we agree with the methodology used for forecasting non-load related capex and the corresponding results. We agree that the RIIO-1 actual average expenditure should be representative of the efficient expenditure needed to deliver a safe, resilient and environmentally sustainable network.

We agree that the clawback should be included to ensure that NGET is not funded again for expenditure that was allocated for RIIO-1, and where the company has significantly underspent its allowance. Our January report to Ofgem highlighted our concern that NGET had simply delayed discretionary expenditure from RIIO-1 to RIIO-2. Our view was based on the lack of evidence to demonstrate that underspend in RIIO-1 had been due to efficiency improvements.

NGET's plan shows that satisfactory asset health and NARM output targets should be achieved by the end of RIIO-1 period. However, we note that the proposed NARMs output for NGET in the DD (after volume adjustments) is significantly lower than might be expected at the end of the RIIO-2 period, potentially increasing the risk to network resilience. We are concerned to see from the information in the Atkins annex that NGET may not have accurately calculated their NARMs data. We welcome that additional evidence will be examined before final determination, in so far as that is possible.

As a result, it is unclear whether NGET assets are in a satisfactory condition, if data is accurate, or if future output targets have been appropriately calculated. To address this, we think that Ofgem should have sufficient time to examine this further so that a reliable mechanism can be put in place. We would suggest that a licence obligation requires an independent assessment of asset condition and NARMs information to be delivered to Ofgem within a limited timeframe; firstly to justify efficient in-period NLRE, and secondly to provide Ofgem with the ability to take action, as necessary.

Q13. Do you agree with our proposed allowances in relation to non-operational capex? If not, please outline why.

We agree with the methodology used for forecasting non-operational capex and the corresponding results. For IT projects, we agree that projects that are uncertain in terms of scope and costs should be excluded and made subject to an uncertainty mechanism.

Q14. Do you agree with our proposed allowances in relation to network operating costs? If not, please outline why.

We agree with the methodology used for forecasting network operating costs and the corresponding results. We agree that there should be no PCDs for this area.

Q15. Do you agree with our proposed allowances in relation to indirect operational expenditure? If not, please outline why.

We agree with the methodology used for forecasting indirect operational expenditure (Business Support and CAI) and the corresponding results. We agree there should be no PCDs for this area.

Q16. Do you have any other comments on our proposed allowances for NGET?

We have not been able to consider Ofgem's assessment of cyber security expenditures. We strongly endorse the need for all companies to comply with required standards but that this should also consider value for money solutions. We respect that such information should be expected to be confidential, but would welcome reassurance that both performance standards and value for money are realised in the final determination.

Q17. Do you agree with our proposal to use a funding route more directly linked to actual engineering work on individual projects, and to provide a further route for funding through a re-opener window?

Yes, given the uncertainty with NGET's expenditure proposals and with the experience of underspend in RIIO-1, we strongly agree with this approach.

We do not think that a volume driver mechanism is appropriate for boundary capability projects given the considerable variations in potential solutions and the limited evidence available to design appropriate volume drivers. There is a high risk for consumers, as shown in RIIO-1, that an incorrect design of revenue drivers will lead to higher than necessary costs. We agree that the PCD approach should be used for baseline projects, and MSIP and LOTI for future projects. This should both protect consumers from higher than necessary costs and ensure NGET is funded for additional efficient expenditure.

As far as approval of projects are concerned, we consider that recent experience from the TIRG, SWW and RIIO Mid Point Reviews have demonstrated that such decisions can be taken without delays to investment or procurement decisions.

Q18. Do you agree with our proposal to reject NGET's UIP UM?

We are conscious that this proposal had strong stakeholder support and we agreed that it was innovative and had the potential to deliver benefit in deprived urban areas but we agree that in the absence of the provision of the details outlined in 4.27 this UM should be rejected on the basis that it is too unclear in terms of scope, coverage and benefits.

Q19. Do you agree with our proposal to provide a UIOLI allowance for offsetting capital carbon emissions?

We agree that NGET's commitment to deliver net zero carbon capital emissions shows welcome ambition, although we have expressed reservations generally about use of offsetting to achieve GG reductions. The proposal to convert NGET's PCD to a UIOLI UM seems appropriate given the uncertainty surrounding costs.

Q20. Do you agree with the level of proposed NIA funding for NGET?

We agree with Ofgem's assessment of NGET's innovation proposals. We would expect more innovation to be funded as BAU.

6. SPT

In our January report to Ofgem, we expressed our concerns that SPT totex appeared higher than necessary. We identified that

- NLRE volumes and unit costs were higher than RIIO-1 historic run rates for a similar asset base
- LRE expenditure was uncertain and should be subject to uncertainty mechanisms
- Increased opex and non-operational capex expenditure was not justified.

As such, we strongly support the evidence-based approach that Ofgem has taken in reducing the baseline expenditure for SPT, while retaining the option for expenditure to be added if either further evidence is provided by final determination, or through the use of uncertainty mechanisms during the price control.

Overall, we agree with the approach to outputs for SPT. We have provided our comments on common outputs elsewhere in our response and address the specific SPT outputs in this section.

Outputs

SPTQ1. Do you agree with our proposals on the bespoke ODIs? If you disagree, please outline why.
We agree with the approach taken on bespoke ODIs as detailed below.

We agree that the 'Stakeholder Engagement Plus' ODI-F proposed by SPT should be considered as BAU and rejected.

SPTQ2. Do you agree that SPT's bespoke ODI-R would be in the interests of existing and future consumers and do you have any views on the proposed metrics to track SPT's progress in delivering the ODI-R?

We have previously expressed our support for this, including the addition of biodiversity targets for some of the sites, which we consider has clear potential to deliver benefits for existing and future consumers. The proposed metrics and reporting requirements seem sensible.

SPTQ3. Do you agree with our proposal to reject SPT's bespoke ODI-F at this time?

We agree that constraint costs should be optimised through improved outage management, but this should be business as usual and be applied as a licence obligation on the ESO and TOs. Any additional incentive mechanism should only be established once it is clear that it can deliver additional benefits over those already available.

<u>Reject: Additional contribution to the low carbon transition ODI-F</u>

SPTQ4. Do you agree that SPT's bespoke ODI-F should be rejected?

We welcome initiatives to deliver the low carbon transition but agree that this is not sufficiently well developed to implement and does not include clear performance measures or offer good value for money in terms of carbon reduction. We therefore agree with rejection as an ODI-F but would welcome equivalent stretch commitments being developed under the EAP.

SPTQ5. Do you agree with our consultation position to reject the "RIIO-T2 System Outage Management Proposals to Reduce Constraint Costs"?

We agree that constraint costs should be optimised through improved outage management, but this should be business as usual and be applied as a licence obligation on the ESO and TOs. Any additional incentive mechanism should only be established once it is clear that it can deliver additional benefits over those already available.

SPTQ6. Do you agree with our proposals on the PCDs? If not, please outline why.

We agree with Ofgem's proposals for accepting and rejecting PCDs based on the evidence provided.

SPTQ7. Do you agree that SPT's bespoke Net Zero Fund should be included in RIIO-ET2?

We welcome that SPT has included this fund to deliver tangible low carbon outcomes to vulnerable communities. Given this is funded by customers, we agree that it will be important that full transparent monitoring of decisions, costs and benefits are published to demonstrate if this scheme is delivering tangible benefits. A 'use it or lose it' approach appears appropriate for this initiative.

SPTQ8. Do you have any views on the conditions we are proposing applying to SPT's bespoke output?

The proposed conditions seem appropriate to ensure accountability.

SPTQ9. Do you agree with our proposals on the CVPs? If not, please outline why.

We agree with Ofgem's proposals on CVPs.

Overall, we agree that the majority of SPT's CVP proposals are what we would expect to be included as business as usual or are addressed elsewhere in regulatory arrangements. Although we considered that the Net Zero Fund proposal had merit we did not look at quantification of benefits and agree that if there is insufficient evidence to support the methodology (and absence of consumer support) this should not qualify for a CVP reward.

SPTQ10. Do you agree with our consultation position to accept the maximise benefit from non-operational land CVP?

As indicated in our January report we think this is a clear and low-cost proposal delivering benefits both in terms of carbon saving and biodiversity. The quantification of benefit and proposal for addressing non-delivery seem appropriate.

Totex

Overall, we agree with Ofgem's proposals for cost and volume reductions based on the evidence provided. We agree that the level of information provided, including evidence to justify expenditure, was comprehensive.

We welcome that Ofgem's approach has been to assess in detail the evidence provided by the companies to justify expenditure, and that there is an opportunity for companies and Ofgem to consider further evidence before final determinations.

SPTQ11. Do you agree with our proposed allowances in relation to load related capex? If not, please outline why.

We note that SPT requested £486m of LRE capex and that Ofgem has removed £114m to give a total of baseline total of £372m. We agree with the methodology used and with the degree of confidence currently attributed to these costs.

We think it is important that the regime for load related expenditure should reflect this uncertainty in order to ensure that the baseline expenditure is not set at too high a level, while also ensuring that all necessary expenditure may proceed. We think that as much as possible of LRE should be subject to PCDs or UMs.

SPTQ12. Do you agree with our proposed allowances in relation to non-load related capex? If not, please outline why.

We note that Ofgem has reduced SPT's NLRE bid from £452m to £320m. Ofgem has highlighted the weaknesses in need case evidence and the lower confidence in some NLRE with which we would agree. We note that SPT has been requested to provide independent cost information to support a higher confidence rating for elements of the NLRE submission. Overall, we agree with the methodology used for forecasting non-load related capex and the corresponding results.

SPTQ13. Do you agree with our proposed allowances in relation to non-operational capex? If not, please outline why.

We agree with the methodology used for forecasting non-operational capex and the corresponding results. For IT projects, we agree that projects that are uncertain in terms of scope and costs should be excluded and made subject to an uncertainty mechanism.

SPTQ14. Do you agree with our proposed allowances in relation to network operating costs? If not, please outline why.

We agree with the methodology used for forecasting network operating costs and the corresponding results. We agree that there should be no PCDs for this area.

SPTQ15. Do you agree with our proposed allowances in relation to indirect operational expenditure? If not, please outline why.

We agree with the methodology used for forecasting indirect operational expenditure (Business Support and CAI) and the corresponding results. We agree that there should be no PCDs for this area.

SPTQ16. Do you have any other comments on our proposed allowances for SPT? We have not been able to consider Ofgem's assessment of cyber security expenditures.

We strongly endorse the need for all companies to comply with required standards but that this should also consider value for money solutions. We respect that such information should be expected to be confidential, but would welcome reassurance that both performance standards and value for money are realised in the final determination.

SPTQ17. Do you agree with our proposals for a re-opener covering these six non-load related projects?

Yes we agree with this approach and that these uncertain projects should be excluded from the baseline and subject to a reopener and application window.

SPTQ18. Do you agree with the level of proposed NIA funding for SPT? If not, please outline why.

We agree with Ofgem's assessment of SPT's innovation proposals and that additional funding should not be provided. We would expect more innovation to be funded as BAU.

7. SHET

In our January report to Ofgem, we expressed our concerns that SHET totex appeared higher than necessary. We identified that

- NLRE volumes and unit costs were significantly higher than RIIO-1 historic run rates
- LRE expenditure was uncertain and should be subject to uncertainty mechanisms
- Increased opex and non-operational capex expenditure was not justified.

As such, we strongly support the evidence-based approach that Ofgem has taken in reducing the baseline expenditure for SHET, while retaining the option for expenditure to be added if either further evidence is provided by final determination, or through the use of uncertainty mechanisms during the price control.

Overall, we agree with the approach to outputs for SHET. We have provided our comments on common outputs elsewhere in our response and address the specific SHET outputs in this section.

Outputs

SHETQ1. Do you agree with our proposals on the bespoke ODIs? If not, please outline why.

We agree with the approach taken on bespoke ODIs. The continuation of the ENS Compensation Scheme is welcomed, as is inclusion of the ITOMs and ITAMs international benchmarking. While we welcome the acceptance of SHET's 'enhanced reporting framework', it would be useful for Ofgem to explain why it has accepted this reporting mechanism as a bespoke output when similar proposals from other networks were rejected. We agree that transparency is important and would suggest that the publication of the analysis is a licence obligation, ideally with all the TOs participating.

SHETQ2. Do you agree with our consultation position to reject the 'RIIO-T2 System Outage Management Proposals to Reduce Constraint Costs'?

We agree that constraint costs should be optimised through improved outage management, but this should be business as usual and be applied as a licence obligation on the ESO and TOs. Any additional incentive mechanism should only be established once it is clear that it can deliver additional benefits over those already available.

SHETQ3. Do you agree with our proposals on the bespoke PCDs? If not, please outline why.

We agree with the Ofgem proposals for several SHET bespoke PCDs to be included in baseline expenditure. We also agree with the bespoke PCDs that have been rejected.

SHETQ4. Do you agree with our proposals on the CVPs? If not, please outline why.

We agree with Ofgem's proposals for CVPs.

We consider that the majority of SHET's proposals either cover areas which will be adequately incentivised under other mechanisms or did not go beyond business as usual and should not be incentivised.

SHETQ5. Do you agree with our proposal to approve the Biodiversity No Net Loss / Net Gain CVP and do you agree with our proposal to re-quantify the value of it?

We think it is important that CVP proposals provide demonstrable and quantifiable additional benefit. We recognised in our January report that biodiversity net gain was an area where various company proposals appeared to have merit. The SHET Biodiversity CVP could provide additional benefits but we agree with Ofgem that further work to develop a robust methodology to quantify benefits is required. Given that the quantification put forward seems excessive and was not supported by consumer willingness to pay evidence we note that there is some apparent inconsistency in treatment of this CVP in comparison with some others.

Totex

Overall, we agree with Ofgem's proposals for cost and volume reductions based on the evidence provided. We agree that the level of information provided, including evidence to justify expenditure, was comprehensive.

We welcome that Ofgem's approach has been to assess in detail the evidence provided by the companies to justify expenditure, and that there is an opportunity for companies and Ofgem to consider further evidence before final determinations.

SHETQ6. Do you agree with our proposed allowances in relation to load related capex? If not, please outline why.

We note that SHET requested £840m of LRE capex and that Ofgem has removed £123m to give a total of baseline total of £717m. In our January report, we expressed concern about the need case, timing and costs of wider works projects, together with seemingly high levels of pre-construction expenditure. Overall, we agree with the methodology used, the changes made and with the degree of confidence currently attributed to these costs. We welcome that PCDs will be applied for delivery of load related projects.

Entry works - Ofgem has included £92m in baseline expenditure for establishing a new reactive compensation site at Kinardochy by 2024. Given this project scope and timing is dependent upon other several factors, we consider that it might be appropriate to include this project in an uncertainty mechanism and removed from the baseline. We think Ofgem should also consider if the provision of such reactive compensation could potentially be provided by third parties through competition.

SHETQ7. Do you agree with our proposed allowances in relation to non-load related capex? If not, please outline why.

We note that Ofgem has reduced SHET's NLRE bid from £824m to £540m. Ofgem has highlighted the weaknesses in need case evidence and the lower confidence in NLRE with which we would agree. In our January report we raised concerns about the significant increases in NLRE compared to RIIO-1 levels. Overall, we agree with the methodology used for forecasting non-load related capex and the corresponding results.

SHETQ8. Do you agree with our proposed allowances in relation to non-operational capex? If not, please outline why.

We agree with the methodology used for forecasting non-operational capex and the corresponding results.

SHETQ9. Do you agree with our proposed allowances in relation to network operating costs? If not, please outline why.

We agree with Ofgem that SHET has not demonstrated that significantly increased network operating costs were necessary due to the increase in the size and complexity of its network. We agree with the methodology used for forecasting network operating costs and the corresponding results. We agree that there should be no new PCDs for this area.

SHETQ10. Do you agree with our proposed allowances in relation to indirect operational expenditure? If not, please outline why.

We agree with the methodology used for forecasting indirect operational expenditure (Business Support and CAI) and the corresponding results. We agree there should be no PCDs for this area.

SHETQ11. Do you have any other comments on our proposed allowances for SHET? We have not been able to consider Ofgem's assessment of cyber security expenditures.

We strongly endorse the need for all companies to comply with required standards but that this should also consider value for money solutions. We respect that such information should be expected to be confidential, but would welcome reassurance that both performance standards and value for money are realised in the final determination.

SHETQ12. Do you agree with our proposal to accept SHET's subsea cable repair re-opener?

We don't think that customers should bear risks that are within the company's control and can be managed through good business practice, except where it is more cost effective for customers. If this re-opener is accepted, then triggering should only be in defined exceptional circumstances, and should only apply after normal commercial risk mitigation – for example, where warranties or insurance have been exhausted or where commercial risk mitigation is shown not to be cost-effective. Also, if this risk is included, we ask Ofgem to consider how customers may benefit e.g. from a lower cost of equity.

SHETQ13. Do you agree with the level of proposed NIA funding for SHET? If not, please outline why.

We agree with Ofgem's assessment of SHET's innovation proposals.

8. NGGT

NGGTQ1. Do you agree with our proposals for the Customer Satisfaction ODI-F?

We agree this is an important incentive and should be a symmetrical ODI-F. We agree that a higher target should be set to encourage improved performance over RIIO-1, and that a higher floor is appropriate. However, as we said in our original report, we think that NGGT's proposed target of 7.8/10 with a collar of 7.1, which Ofgem has accepted, is not sufficiently stretching as NGGT's most recent performance (in 18/19) is already 7.8. The proposed stakeholder question and incentive range is appropriate.

NGGTQ2. Do you agree with our proposals for the Quality of Demand Forecasting incentive?

We agree with Ofgem that this incentive should be designed to set a target that will drive real improvements in forecasting. We agree that the focus on a D-1 forecasting target and the associated incentive regime, together with reporting obligations, are appropriate.

NGGTQ3. Do you agree with our proposals for the Maintenance incentive?

We share Ofgem's concern that this incentive rewards business as usual – we agree that a downside only scheme to incentivise efficient outage planning would be appropriate. This should minimise disruption to customers and would replicate normal commercial business practices.

NGGTQ4. Do you agree with our proposals for the CCM incentive?

It is important that constraint costs are minimised and the SO incentivised to do so. In an environment of declining gas demand, we agree that historic annual constraint costs of £0.2m p.a. are an appropriate benchmark to set the target. We agree that system entry overrun charges should be excluded as being outside NGGT's control and that the cap/collar and incentive rate of the incentive should be reduced.

NGGTQ5. Do you agree with our proposals for the Residual Balancing incentive?

We agree that that this proposal will deliver benefits for consumers with a lower reward than for RIIO-1.

NGGTQ6. Do you agree with our proposals for the GHG emissions incentive?

Overall, we agree with this symmetrical financial incentive proposal and note it is based on a cost per tonnes of carbon dioxide of £67.95 which sends an appropriate signal of the importance of reducing methane emissions at compressor stations.

NGGTQ7. Do you agree with out proposals for the NTS Shrinkage incentive

We agree that NGGT has very little influence on the level of shrinkage and the incentive is essentially related to efficient procurement of uncertain gas volumes as for most normal industrial customers. We agree that this should be a reputational incentive with a licence obligation to report actual performance, including against 'perfect foresight' comparators.

NGGTQ8. Do you agree with our proposals on the bespoke ODIs? If not, please outline why.

We agree with Ofgem's proposals to accept an Environmental ODI, and a Stakeholder Satisfaction ODI. On the other proposed bespoke ODIs we agree with Ofgem's proposals to reject them on the basis that these are addressed under existing licence obligations, or are included under other ODIs.

For stakeholder satisfaction in relation to new and modified NTS connections it is critical that companies who have had new or modified connections are consulted with as their views are particularly significant given that they are likely to have paid >£1 million for NGGT works.

NGGTQ9. Do you agree with our proposals for the environmental incentive?

Although we had reservations about the case for an ODI related to NGGT's EAP targets we do support the Environmental Incentive ODI-F on the basis of the analysis and detailed proposals in the DD. We consider that the symmetrical nature of the ODI should hold NGGT to account in delivering certain annual environmental targets. We welcome the proposal to recalibrate this incentive to reward the achievement of challenging targets but do have concerns that the multiple incentive rates make the proposal relatively complex.

We invite Ofgem to consider further whether the target for reducing emissions from operational transport is sufficiently challenging given that significant baseline expenditure is being provided for making this conversion.

NGGTQ10. Do you agree with our proposals for the proposed Stakeholder Satisfaction incentive?

We agree that the Stakeholder Satisfaction survey should be an ODI-R but suggest that the annual publication of this report is included as a licence obligation.

NGGTQ11. Do you agree with our proposals on the PCDs? If no, please outline why.

We agree with Ofgem's proposals for PCDs. We note that a significant number of IT projects are subject to UMs and suggest that these are included as PCDs once expenditure approval is given.

NGGTQ12. Do you agree with our proposals for LO in relation to NCAM and ANCAR?

We are concerned that the Ofgem finding that assumptions used in NGGT's analysis has understated the physical capability of the NTS, which could indicate higher than necessary investment needs. We agree that improvements need to be made to the Annual Network Capability Assessment Report and the National Capability Assessment Framework and that this should be a licence obligation. We suggest that NGGT is given an early deadline for meeting this obligation so that network capability can be clearly understood.

We also believe NGGT should be required to publish running hours for each compressor as this is an important measure of capacity utilisation and informs the needs case for investment at compressor stations.

NGGTQ13. Do you agree with our proposal not to set network capability targets for RIIO2?

Yes we agree with this approach given the above approach to reviewing the physical capacity.

NGGTQ14. Do you agree with the proposal to reduce entry baseline capacity at St Fergus?

Yes we agree with this approach on the basis that NGGT has consulted on the reduction. It is still significantly higher than any likely demand for capacity based on the 2019 Ten Year Statement

NGGTQ15. Do you agree with the proposal to reduce entry baseline capacity at Theddlethorpe?

Yes we agree with this approach on the basis that NGGT has consulted on the reduction and the terminal has been decommissioned.

NGGTQ16. Do you agree with our proposals on the CVPs? If no, please outline why.

Overall, we agree where NGGT's CVP proposals have been rejected. We consider they are what we would expect to be included as business as usual or are addressed elsewhere in regulatory arrangements.

NGGTQ17. Do you agree with our consultation position to allow (subject to eligibility under the BPI) the natural environment improvements CVP?

Yes, we agree that this CVP could add value subject to outputs and targets being defined to ensure the delivery of additional benefits.

NGGTQ18. Do you agree with our proposal to re-quantify the value of the CVP?

Yes, we agree that this should be defined and quantified so it clearly delivers outputs above business as usual that add value to customers.

NGGTQ19. Do you agree with our consultation position to accept (subject to eligibility under the BPI) the community initiatives CVP?

As noted in in our January report we think this proposal has strong features and could deliver additional value. We are conscious that there are risks (for example that funding may not be allocated appropriately or that the governance and reporting requirements may be disproportionate) but we note that Ofgem has been provided with satisfactory evidence around the type of initiative NGGT proposes to undertake and the demonstrable benefits these should produce and we think that this is a good proposal with strong stakeholder support that could justify a CVP reward if NGGT is eligible under the BPI scheme.

Totex

Overall, we agree with Ofgem's proposals for cost and volume reductions based on the evidence provided, and the use of uncertainty mechanisms. We agree that the evidence provided offered a low level of confidence about the necessary level of expenditure during the RIIO-2 period.

We welcome that Ofgem's approach has been to use expert consultants to assess in detail the evidence provided by NGGT to justify expenditure, and that there is an opportunity for companies and Ofgem to consider further evidence before final determinations.

NGGTQ20. Do you agree with our proposal to reject the Blackrod Reinforcement project?

We agree with Ofgem's analysis that there is insufficient evidence for this expenditure. The needs case is incomplete, the risk is not established, and the cost forecast is highly uncertain

NGGTQ21. Do you agree with our proposed allowances for LRE?

We note that Ofgem has reduced baseline LRE from £11.6m to £2.4m. We agree with Ofgem's LRE assessment addressing Blackrod, metering, Tirley AGI valves, and customer offtakes and the resultant overall reduction.

NGGTQ22. Do you agree with our proposed GT Project Assessment Process?

We note that Ofgem has reduced baseline NLRE from £899m to £518m, with uncertainty mechanisms proposed for compressor emissions and asset health. Ofgem states that it has limited data to benchmark costs because NGGT does not have historical volume or benchmarking information. This is a serious deficiency and we are concerned with the resultant uncertainty this creates for NLRE cost and volume forecasting. We agree that improvements need to be made to data capture and reporting.

Compressor emissions – FES 2020 forecasts for gas demand indicate an increased future decline, potentially reducing running hours further, and reducing emissions compliance interventions. We agree Ofgem should ensure that all future compressor expenditure is thoroughly assessed for need and value for money. In doing so, we encourage Ofgem to apply NetZero scenarios as the base case for demand forecasts and to fully consider options for efficient interventions.

For example, for the compressor investments and NGGT and Ofgem should explore opportunities arising from leaving the EU in relation to the Medium Combustion Plants Directive, for example by making investment that materially reduces NOX in areas where people live instead of reducing NOX from compressor stations with no impact on people's health.

We agree with the proposed GT project development process where projects are assessed for need case, option assessment, and efficient cost proposals before expenditure approval. We think having funded competitions at the feasibility stage may provide opportunities for innovation and reduce the risk of implementing a sub optimal option. We agree with the Ofgem proposal to include a baseline of £85m compared to the £489m NGGT proposal.

NGGTQ23. Do you agree with our proposal to provide baseline funding for Hatton subject to us conducting further volume and cost assessment prior to our Final Determination?

We note that new evidence was provided in May 2020 to Ofgem to justify this project, which we have not reviewed. We agree with the inclusion of the Hatton compressor project in the baseline allowance, subject to need case and efficient costs being determined by final determination, and the inclusion of a PCD.

NGGTQ24. Do you agree with our proposal to accept the need for investment, provide baseline funding for development work and assess the full project costs during RIIO-GT2 for the compressor projects at Stage 1 - Needs Case Assessment (Wormington, St Fergus, King's Lynn and Peterborough and Huntingdon)?

We agree with the need for funding of development work to enable a future expenditure decision to be taken on these projects. PCDs should be applied if expenditure is approved. Our comment in relation to the Medium Combustion Plants Directive and health given in response to Q22 applies to these projects. We also agree with the Ofgem proposal to fund improved methane emission detection equipment.

Q25. Do you agree with our assessment approach to asset health work, including our proposal to use a combination of baseline funding, PCDs and a UM for the various cost sub-categories?

We note that Ofgem has proposed an asset health allowance of £500m compared to NGGT's bid for £753m (which increased by £15m after plan submission). We have considered Ofgem's assessments for valves, compressors, pipelines, plant & equipment, civils, electrical and cabs. We note that NGGT bid for an average annual allowance of £122m, compared with an expected RIIO-1 annual average expenditure of £87m. Ofgem's proposal is for an average £78m pa for RIIO-2, with uncertainty mechanisms for a) plant & equipment and b) cabs.

We agree with Ofgem's approach to assessing required volumes, covering the need case for investment and the intervention options, taking account of asset condition evidence, maintenance policy, statutory requirements, ability to deliver in RIIO-2, and the future need for the assets.

For cost assessment, we note that Ofgem found NGGT evidence of forecast costs to be of a poor quality. We agree with Ofgem's approach of considering forecasts based on historical actual costs as high-confidence, and in adjusting forecast costs for scope consistency, data accuracy and actual market testing data.

Overall, we think that Ofgem's proposals for baseline asset health expenditure are appropriate. We welcome that the majority of NGGT's asset health plan is covered by the NARM mechanism and an associated PCD. We also welcome the additional PCD defined for the remaining £87m of NGGT asset health expenditure.

Q26. Do you agree with our proposed approach for costs confidence, including our view and rationale for high and low confidence cost categories and costs subject to a BPI Stage 3 penalty?

We agree with the methodology and evidence-based approach that has been used and the corresponding results. We welcome that further evidence may be considered before FD.

NGGTQ27. Do you agree with our proposed approach to approve the need for investment, provide development funding and assess the full project costs through a UM during RIIO-GT2, for the Bacton, St Fergus subsidence and King's Lynn subsidence projects?

We agree that these projects are sufficiently uncertain such that reopeners and PCDs are appropriate. This should ensure that delivery and cost overrun issues such as those apparently illustrated at Peterborough and Huntingdon compressor projects should be addressed.

NGGTQ28. Do you agree with our proposed baseline allowances for Stopples, GRAID and decommissioning of redundant assets and compressors?

We agree with the proposed baseline funding of £10m (based on historic costs) for Stopples to minimise network outages; the £10m funding for GRAID based on Ofgem's adjustments, and for decommissioning costs of £82m. We agree a PCD should be applied to decommissioning expenditures.

Q29. Do you agree with our proposed assessment approach and baseline allowances for non-operational Capex costs, including IT&T, STEPM, property and vehicle fleet investment?

We note that NGGT has bid for £297m of non-operational capex and that Ofgem has proposed baseline expenditure of £68m. This reduction is primarily a result of reductions to the allowed IT & Telecoms allowance for TO and SO capex. We agree with Ofgem's proposals that these projects are not sufficiently well scoped or costed to be included as baseline expenditure, and that 60 of the proposed 66 projects should be considered under an uncertainty mechanism.

In considering the needs cases for future IT&T expenditure, and the scope of proposed solutions, we think Ofgem should take full account of the future operational requirements of the gas network with an expected decline in gas demand.

On vehicles, we welcome that NGGT proposes to transition to EVs and agree that unit costs should reflect the declining cost forecasts for EVs. We would question why NGGT should be funded for installation of EV infrastructure which could be competitively provided.

Overall, we agree with Ofgem's proposals for non-operational capex expenditure.

NGGTQ30. Do you agree with our proposed allowances for Physical Security Capex and Opex?

We strongly endorse the need for all companies to comply with required standards but that this should also consider value for money solutions. We welcome that Ofgem has assessed security asset refresh costs and reduced expenditure that was not justified.

On cyber, we respect that such information should be expected to be confidential but would welcome reassurance that both performance standards and value for money are realised in the final determination.

Q31. Do you agree with our assessment approach and baseline allowances for NGGT's Opex costs, including network operation costs, BSC, CAI and Quarry and Loss?

We note that NGGT has bid £200m of TO direct opex, of which Ofgem has proposed £190m as a baseline, and that NGGT has bid £156m of SO direct opex which has been accepted without change by Ofgem. We agree with Ofgem's assessment approach which compared forecast and historical trend data on a consistent basis, and which led to a reduction in Inspection & Maintenance costs.

For business support and CAI costs, we note that NGGT has requested £163m for business support and £156m for CAIs, and for its SO activities it has requested £114m for business support and £49m for CAIs. Ofgem's proposals reduce business support baselines slightly based on regression analysis and IT&T expert review. We note that Ofgem used similar techniques for CAI costs but reduced TO CAI to £70m to remove costs that should have been capitalised. We agree with Ofgem's approach to assess business support and CAI costs.

For quarry and loss, we agree with the proposed baseline reductions to reflect historical evidence and note that an uncertainty mechanism is proposed.

Q32. Do you agree with our proposed approach to Pensions costs?

Yes, we agree these should be updated with the outcome of the pension reasonableness review in November 2020.

NGGTQ33. Do you agree with our proposed approach to assessing risk?

Ofgem has proposed that cost uplifts for risks on capital projects may be included where justified, and that these will be capped at a maximum of 10% of project costs. We agree that this approach is appropriate and is reflective of normal commercial practice. We agree that risk uplifts should not be included for costs based on actual outturn.

Uncertainty mechanisms

Q34. Do you agree with our proposed UM for incremental capacity, specifically the timing and content of the Pre-Application Notification stage, the Needs Case and Cost Assessment timings, and the need for an exceptional events mechanism?

We agree that the proposed UM for incremental entry/exit capacity is an appropriate approach and should be project driven when needed. We agree this should be a transparent/public process with an assessment of need case, costs and stakeholder views. We welcome that PCDs will be used and that the late competition model may be applied.

NGGTQ35. Do you agree with our proposed UM, materiality threshold and trigger for pipeline diversion costs?

In the event that pipeline diversions are required, we agree that there should be a reopener for pipeline diversion cost subject to the liability, need case and efficient cost being evidenced.

Q36. Do you agree with our decision to retain a UM for Quarry and Loss costs relating to loss of development and mineral sterilisation only, and do you agree with our proposed UM parameters?

In the event that these costs are claimed, we agree that there should be a reopener for subject to the liability and efficient cost being evidenced.

Q37. Do you agree with our proposed asset health UM, specifically basing the UM on improved quality of cost data and volume measurement and assessing costs ex post?

We note that Ofgem has been unable to reach a view on compressor station auxiliary plant and equipment and cab infrastructure, while recognising that there is a need case for further expenditure. Ofgem notes that evidence provided to justify costs and volumes were limited, inconsistent, and unclear. Ofgem states that neither they nor NGGT appear to know the true cost of delivering this work.

We agree that it is important to ensure that asset health is maintained, but that this should be efficient expenditure against clearly evidenced need cases, intervention choices and efficient costs. In a future environment where gas demand and asset utilisation are falling, we are concerned that such expenditure is defined as clearly as possible. We therefore support Ofgem's proposal to use an asset health UM during the price control for ex-post approval of efficient costs, and approval of future costs.

Q38. Do you agree with our proposed GT Opex escalator adjustment mechanism?

We agree with the proposed approach to calculate the CAI adjustment mechanism.

Innovation

Q39. Do you agree with the level of proposed NIA funding for NGGT? If not, please outline why.

We agree with Ofgem's assessment of NGGT's innovation proposals. We also support an improved process for innovation across all the gas companies with duplication avoided and the innovation net cast wider than it has been in the past. We would expect more innovation to be funded as BAU bringing technology to the UK that has been developed in overseas gas industries.

9. Gas Distribution Sector

Output consultation questions

GDQ1. Do you have any views on our common outputs that haven't been covered through any of the specific consultation questions set out elsewhere in this chapter? If so, please set them out, making clear which output you are referring to.

Customer service survey - We support Ofgem's proposals to introduce penalties in this area as soon as service levels fall below the new average targets achieved in the customer service survey trials, and without the cushion of a penalty-free dead band. This is particularly important because the efficiency targets set by Ofgem could be a strong incentive for the companies to let improved service standards slip. We do, however, support Ofgem's introduction of a deadband so that only material improvements in service - those in the upper quartile range - receive additional rewards.

Complaints - The proposed minimum performance level for complaints seems reasonable although it appears that this could have been more demanding were it not for the relatively poor performance of the Cadent companies in RIIO-1.

Unplanned interruptions – The approach of setting a penalty trigger based on an 'excessive deterioration' of each company's current performance looks reasonable.

GSOPs: We welcome Ofgem's proposed changes.

GDN record keeping, including MOBs – Ofgem is considering how to ensure that GDN record keeping should evolve over RIIO-2, with a particular focus on records for multiple occupancy buildings. The draft determinations propose that this will be addressed at some stage during RIIO-2 with the possibility of introducing a licence obligation to enforce record keeping. We think Ofgem and companies must be more proactive and suggest that a licence obligation is put in place with a deadline to have an acceptable regime in place early in RIIO-2.

Use It Or Lose It (UIOLI) allowance **-** This is a £30m package divided up pro-rata with £5m in a collective pot - funding goes beyond the level identified in GD1. Ofgem has indicated that several bespoke measures should be funded from the UIOLI funding envelope. But, if all bespoke measures were funded by UIOLI funding, NEA has calculated this would leave little headroom for companies to deliver other strategies. It is not clear what the balance of outcomes will be – for example, CO vs vulnerability vs affordability. It is also unclear whether the projects that were proposed and supported by consumer evidence will be delivered if moved to BAU or under other funding envelopes.

Vulnerability minimum standards - We have not seen the new licence condition which needs to be in place before GD2 starts. As such we are limited in comments about how effective outputs in this area will be. This is important because Ofgem has set expectations that a number of bespoke outputs and proposals are included in BAU, but we would appreciate having more confidence that this means companies will deliver these valuable outputs.

Vulnerability-related bespoke outputs **-** There was a particularly ambitious package proposed by Cadent - so it is disappointing that so much has been rejected. We challenge Ofgem to consider if this is still appropriate in light of Covid-19 (see 'Outputs related to vulnerability' p11 in our main response for more on this). We support the areas that Ofgem has accepted as bespoke outputs, or may accept with more evidence.

<u>Sub deducts off risk</u> – We note that Ofgem has assumed that RIIO-1 funding should result in all gas pipes on the customer side of GDN meters should have an owner responsible for them, and as a result this output has been removed for RIIO-2. We suggest that a licence obligation should be included from the start of RIIO-2 to ensure all GDNs are compliant with this important requirement.

<u>Gas holder demolitions</u> – Ofgem has proposed not to apply PCDs for gas holder removal due to the expectation that no GDNs will have gas holders on their networks by the end of RIIO-2. We are keen to see a regime established which ensures that companies are only funded for the successful delivery of this output.

<u>NARM</u> – we think the NARM outputs are a critical aspect of the price control and support that their deployment and incentivisation. We have provided our comments on the overall regime in response to questions in the NARM annex.

GDQ2. What are your views on the reporting metrics we have proposed for the consumer vulnerability ODI-R?

GDQ3. What are your views on the design of the annual showcase events, including whether they should be held at a national or regional level?

We are happy with proposals for the annual showcase. We encourage Ofgem to include standardised SROI requirement in reporting when available, as this is being worked on by networks even if it isn't ready for the start of RIIO-2. We think Ofgem could have considered a metric that took account of high quality PSR sign up rather than simple volumes, this could have provided a reputational incentive for companies to compete.

GDQ4. Do you agree with our position to change the FPNES from a PCD to a capped volume driver?

We welcome the volume driver that could extend delivery of FPNES beyond company targets. We wonder if Ofgem has taken account of the Green Home Grants fund as this may make it easier to target more connections in some areas. We are concerned about the change in the incentive from PCD to ODI-R with a capped volume driver. We think this reduces the penalty for under-delivery in this area. We urge Ofgem to consider net zero aspects of FPNES for FD as it has elsewhere in the package. For example, it could consider opportunities to go harder to tackle solid fuel heating, hybrid heat solutions or other creative solutions.

GDQ5. For GSOP3, is a 48 hour exclusion period for the provision of access to hot water and food in the event of a major incident appropriate? Should this be extended to cover interruptions that are not a major incident?

GDQ6. In relation to our proposal to extend quotation GSOPs on entry and exit connections, is it sufficient – in regard to green gas entry enquiries – for these GSOPs to apply to the provision of initial and full capacity studies? Are there other parts of the green gas entry process we need to consider to ensure an improved service provision?

We note that a longstanding concern from the biomethane industry is that all four GDNs apply different rules and insist on different designs for grid entry units, leading to increased cost and complexity. Priority should be given to moving to a standard design.

In addition, the detailed rules for green gas entry in relation to calorific value and propane enrichment lead to significant flaring of biomethane each time there is a plant start-up for grounds related to billing technicalities not related to biomethane, with no safety impact or impact on customers. We suggest the GDNs should, as a matter of priority, be required to introduce technical changes to reduce this flaring.

GDQ7. What are your views on our consultation position to monitor the provision of and adherence to appointment timeslots for purge and relight activity through an ODI-R? Are our suggested reporting measurements reasonable?

It is positive that Ofgem has accepted that companies' engagement has identified a consumer appetite for time-bound appointment slots for 'purge and relight' activities. However, given the efficiency expectation made of companies, we are concerned that a common reputational incentive will not be enough to ensure this is delivered. We suggest that Ofgem looks to strengthen this incentive, for example, by including it as a licence condition.

GDQ8. Do you agree with our proposed option to provide Cadent and SGN with consumer funding through totex baseline or a financial ODI reward for collaborative streetworks activities?

We welcome the proposal to provide funding to Cadent and SGN, to undertake collaborative streetworks activities with other utilities. We support this being funded through an ODI-F as we consider that SGN made a good case for why this type of incentive would help deliver most consumer value. We suggest that, given the significant consumer benefit that could result from these activities, Ofgem works with the two companies to set up these trials in such a way that any learnings will help this output be rolled out to all GDNs in RIIO-3.

GDQ9. How should we set targets for the shrinkage financial incentive?

GDQ10. Do you have any views on what clarifications are needed to ensure a consistent method of calculating the benchmark shrinkage volumes?

GDQ11. Do you think a deadband should apply to the financial incentive? If so, please provide evidence as to how this could be quantified.

We agree with the importance of reducing gas losses and that shrinkage reduction targets should be set and incentivised. We agree with the use of a reputational ODI to report shrinkage and that this should be reported on in the companies' Annual Environmental report.

GDQ12. What are your views on our consultation position for the four GDNs' EAP proposals in RIIO-2 as set out in this document?

As noted in our comments on the EAP overarching framework (see 'Environmental outputs', p12, in our main response) we are generally supportive of the framework and Ofgem's intention to accept companies' EAP commitments with minor amendments, but have a few reservations about the DD proposals (substitution of EAP commitment/baseline funding for PCDs on grounds of materiality and exclusion of climate change adaptation from the AER - we consider that strategic planning for the impact of climate change is closely tied to sustainability and an important issue to cover in the EAP and report on in the AER, even though specific measures will be part of resilience expenditure. As regards the specific EAP proposals for the GD sector:

- We support the inclusion of an ODI-R for BCF reduction to assist transparency and highlight the impact of the companies' actions in this area and agree that targets should be represented to assist comparability before the start of RIIO2. We agree that both BCF reduction excluding shrinkage and shrinkage should be reported in the AER.
- As regards commercial fleet transitioning see our comments on the over-arching framework (in particular need to avoid distorting incentives to adopt the most appropriate fuel technology).
- We note that in several areas Ofgem is encouraging GDNs either to adopt targets or to adopt more ambitious targets. For reasons noted elsewhere we are concerned that the incentives to do this are weak.

GDQ13. Do you agree with our consultation position to include progress on biomethane in GDNs' AERs, alongside standard connections data?

As stated in response to GDQ6, we support improvements in the overall process to reduce costs and the flaring of biomethane. It is possible there will be hydrogen injection into the GDN networks during the RIIO-2 period and it is important that a unified set of engineering standards and policies are adopted, avoiding the issues with biomethane from each GDN going its own way.

We think there should be a licence obligation for GDNs to report on all stages of the connection process, from enquiries through to offers, and connection delivery. It should also report on barriers to biomethane connections.

We welcome the funding for SGN to rollout innovative technology to support increased biomethane injection but believe this should apply to all the GDNs as the pace of innovation, particularly in relation to capacity, needs to be country wide and is urgent given that absence of capacity is a significant issue which is holding back growth of green gas.

GDQ14. Do you have any other comments in relation to this section?

No further comments

GDQ15. What are your views on the proposed set of Workload Activities for the Tier 1 mains replacement PCD?

We think the proposed workload activities for Tier 1 iron mains replacement are appropriate, covering three different types of intervention for four different mains diameters. We think this is a proportionate approach which will allow costs and volumes to be appropriately targeted and monitored.

GDQ16. What are your views on our proposal to adjust allowances for the Tier 1 mains replacement PCD on the basis of mains decommissioned?

In principle, we think this is a proportionate and appropriately simple approach.

GDQ17. What are your views on our proposed approach to setting unit costs for the Tier 1 mains replacement PCD?

We note that Ofgem proposes to use industry average unit costs (plus regional factors) to derive distribution network specific unit costs. However, we note that the use of average costs will lead to gains for companies that have lower than average costs. We suggest that the totex sharing factor is applied to these savings so that customers can share these savings.

GDQ18. What are your views on our proposed Allowance Adjustment Mechanism and Allowance Adjustment Restrictions for the Tier 1 mains replacement PCD?

We think it's appropriate that the RIIO-2 closeout should accurately reflect the outputs that the companies have delivered.

We agree that these adjustments should not fund delivery of additional workload above baseline targets, and that over performance should be rewarded through the NARMs incentive.

For under-delivery, we note that Ofgem has proposed a reputational incentive and the option of adjusting RIIO-3 allowances rather than a financial penalty. We are concerned that this incentive may be insufficient, and companies may delay this expenditure or deliver the cheaper outputs. We suggest Ofgem considers additional delivery incentives during RIIO-2.

GDQ19. What are your views on our proposed Workload Activities for the Tier 1 services PCD?

We agree the four proposed workload activities are appropriate.

GDQ20. What are your views on our proposed approach to setting unit costs for the Tier 1 services PCD?

We agree the proposal to use distribution network specific unit costs is appropriate.

GDQ21. What are your views on our proposed Allowance Adjustment Mechanism and Allowance Adjustment Restrictions for the Tier 1 services PCD?

We agree that these adjustments should not fund delivery of additional workload above baseline target plus 10%, and that performance above this level should be rewarded through the NARMs incentive. We think it's appropriate that the RIIO-2 closeout should accurately reflect the outputs that the companies have delivered.

For under-delivery, we note that Ofgem has proposed the option of adjusting RIIO-3 allowances rather than a financial penalty. We are concerned that this incentive may be insufficient, and companies may delay this expenditure or deliver the cheaper outputs. We suggest Ofgem considers additional delivery incentives during RIIO-2.

GDQ22. What are your views on our proposal for a common PCD for capital investments?

GDQ23. What are your views on our proposals for delivery, clawback and deliverables for the capital projects PCD?

We note that Ofgem has accepted £267m of specific capital projects e.g. the NGN TransPennine Rail Electrification project, in baseline allowances and proposed that each of these projects will be subject to a PCD. We agree that a common approach should be taken to these projects such that each investment such be assessed separately, and the scope and cost agreed on an ex-ante basis.

The PCD mechanism is proposed to claw back funding if the project doesn't go ahead (in full or in part). We suggest that these projects may be better treated under uncertainty mechanisms so that costs and PCDs may be agree when there is greater certainty that the projects will go ahead.

GDQ24. Do you agree with our approach for funding physical security for the GD sector? And do you agree that in light of the proposed baseline totex that the physical security PCD is no longer required for the GD sector?

We agree that the low materiality of physical security costs mean that a PCD is unnecessary.

GDQ25. Do you consider that the enhanced obligations framework for exit capacity and the additional information being sought are appropriate?

Efficient exit capacity booking arrangement between GDNs and NGGT are important to ensure efficient network capacity utilisation. However, given the NTS is generally not capacity constrained due to the decline in CCGT generation, we agree the need for an OFI-F incentive has reduced, and that a licence obligation for enhanced exit capacity reporting is appropriate.

<u>Approach to Cost Assessment Consultation Questions</u>

GDQ26. Do you agree with our proposal of using a top-down regression model?

We agree with Ofgem's cost assessment approach to use a top down totex regression model, with non-regression analysis for specific benchmarked cost items e.g. MOBs, and with technical assessment e.g. IT&T where this is not suitable and costs are company or project specific.

We welcome that Ofgem considers that 92% of forecast costs were assessed using regression or non-regression analysis and 84% were assessed using regression analysis. This should enhance confidence in the results.

GDQ27. Do you agree with our proposed approach to benchmarking modelled costs at the 85th percentile?

We think it is important to reward efficient companies and incentivise less efficient. We agree that the 85% level is an appropriate benchmark which should both reward the most efficient companies and incentivise less efficient companies to improve.

GDQ28. Do you agree with our proposed approach to estimating embedded ongoing efficiency and values calculated?

We agree that a challenging ongoing efficiency target should be set for RIIO-2 and agree with the additional challenge and methodology proposed.

<u>Normalisation Consultation Questions</u>

GDQ29. Do you agree with our proposed pre-modelling normalisations?

We agree that regional factors and unjustified costs should be removed before benchmarking is performed.

<u>Model Selection Consultation Questions</u>

GDQ30. Do you agree with the selected aggregation level, estimation technique and time period for our econometric modelling?

We agree that the top-down aggregation approach is appropriate and the GD1 to GD2 period (once adjusted for non-consistent cost activities). However, we are concerned that this may be distorted by higher than necessary cost forecasts provided by companies for RIIO-2.

Meterwork adjustment - We do not think that there should be an upward adjustment for metering labour costs to be included in the price control – companies should be managing this loss of activity given it has been a process underway for many years.

GDQ31. Do you believe we should take into consideration revised cost information for the remainder of GD1 including 2019-20 (actuals) and 2020-21 (forecast)?

Yes, if there is a material change, we think latest actual information should be used to improve accuracy.

Opex Consultation Questions

GDQ32. Do you agree with our selected cost drivers for Opex?

Yes we agree that the proposed mix of MEAV, customer numbers, and condition reports is appropriate.

GDQ33. What are your views on our proposed approach to the synthetic cost driver for repex?

Yes, we agree that synthetic cost driver including defined repex activities and unit cost is appropriate.

GDQ34. What are you views on our proposed repex workload adjustments?

We agree that repex adjustments should be made if the need case is not justified. We agree that full consideration should be given to deferring all or part of asset management investments. We welcome the CBA cut-off of 16 years to mitigate the risk of stranded investment, given the uncertain future of the gas network.

We note that Ofgem has disallowed £548m of proposed asset management investments and made a further £141m of adjustments to mandatory costs, with other expenditure moved from baseline to bespoke PCDs and uncertainty mechanisms. This should help mitigate the risk of stranded investment while still ensuring that safety and decarbonisation targets are realised.

We agree that dynamic growth or acceleration of Tier 1 expenditure should be removed given the uncertainty of future forecasts and the declining size of the Tier 1 population. We also agree that Tier 1 stubs should be removed from baseline expenditure into a reopener mechanism given the uncertainty whether this expenditure will be required.

GDQ35. Where we have disallowed workloads, should we consider making corresponding adjustments to opex costs? If so, how do you think this could be done?

If there is a material change, then the proposed opex cost driver formulation could be an appropriate means of adjusting opex.

Capex consultation questions

GDQ36. What are your views on our proposed approach to the synthetic cost driver for capex?

GDQ37. What are you views on our proposed capex adjustments?

We agree this synthetic cost driver is an appropriate approach, and that the workload adjustments for SGN reinforcement projects are appropriate.

Non-regression Costs Consultation Question

GDQ38. Do you agree with our assessment of non-regression costs and our proposed adjustments?

We note that Ofgem has assessed the following non-regression costs:

- MOBs - £6m of downward reductions to align with historical run rates
- Streetworks - based on current run rates and disallowance of costs related to penalties
- Repex diversions - £15m of downward reductions to align with historical run rates
- Smart metering - a reduced total of £42m for upstream fault costs has been assessed.
- Land remediation – GDN forecasts of £38m accepted
- SIU opex – SGN's forecast accepted
- Growth governors - £8m of downward reductions to align with benchmarked costs

Overall, we think the approach is appropriate.

Technically Assessed Costs consultation questions

GDQ39. Do you agree with areas selected for technical assessment?

GDQ40. Do you agree with our proposed approach?

We note that Ofgem has assessed the following areas for technical assessment:

- bespoke outputs – where £48m of a proposed £356m was accepted
- large repex projects – two SGN projects were accepted with some cost disallowances
- large capex projects - some downward adjustments made
- Information Technology and Telecoms capex – some elements included in uncertainty mechanism
- Physical Security Upgrade Programme
- Gasholder demolition - small adjustments proposed based on historic evidence

Overall, we agree with the areas and think the approach is appropriate.

Technically Assessed Costs Consultation Questions

GDQ41. Do you agree with our proposed disaggregation methodology?

We agree with this approach to determine costs at an activity level for PCDs.

Uncertainty Mechanisms consultation questions

GDQ42. Do you have any views on our common UMs that haven't been covered through any of the specific consultation questions set out elsewhere in this chapter? If so, please set them out, making clear which output you are referring to.

Overall, we welcome the approach that Ofgem has taken to uncertainty mechanisms which appear to strike a good balance between ensuring that baseline allowances only include necessary and efficient investment and enabling any additional expenditure to benefit consumers to be funded. The mechanisms should also provide additional revenue certainty to the companies. We generally agree with the list of UMs in Table 31.

We welcome that the HSE reopener is designed to be triggered in the event of a material change to the iron mains replacement programme resulting from a change to safety legislation. However, we are concerned that no initiatives are planned to determine if it is to customers' benefit to change this policy.

We would urge Ofgem to take the lead in collecting evidence to provide to the Government and the HSE about the cost and risk associated with changes to the iron mains replacement programme. Such evidence should include examination of expenditure, safety risk and methane leakage risks, considering whether the target completion date for the mains replacement programme is appropriate. It can also take account of the impact of residual leakage if the network is repurposed to hydrogen.

GDQ43. What are your views on the proposed re-opener for Tier 1 stubs?

Given the uncertainty about Tier 1 stubs, we agree that the expenditure should be removed from baseline and an uncertainty mechanism established.

GDQ44. What are your views on our proposal to introduce a <7bar diversions re-opener?

We agree that, if costs cannot be recovered from third parties, these should be beyond the control of GDNs and that a reopener is required. We agree that a 1% revenue trigger threshold appears appropriate.

GDQ45. What are your views on the triggers and windows for the MOBs safety re-opener?

We agree that a reopener is the most appropriate way of implementing any new safety standards for MOBs.

GDQ46. What are your views on our consultation position to address bespoke decarbonisation of heat re-openers through our proposed innovation stimulus, Net Zero and Heat Policy re-opener mechanisms?

Decarbonisation of heat is a critical issue but the way forward and future policy is uncertain. We note that Ofgem has identified five potential triggers for the Heat Policy reopener:

- Gas quality regulations
- Connection charging arrangements for distributed entry e.g. for biomethane
- Domestic connection charging arrangements
- Changes to GDN obligations e.g. for energy efficiency
- Other government policy that impacts the gas networks

We think this is an appropriate mechanism and welcome that this policy risk and triggers have been identified.

GDQ47. What are your views on the questions set out in paragraph 4.57 of this document in relation to large hydrogen projects?

We welcome the proposals from GDNs to determine whether transition to full or blended hydrogen networks is a safe and cost-effective path towards achievement of net zero targets.

We agree that large hydrogen projects should not yet be funded through baseline expenditure, and should be considered through innovation funding (including Government funding) initially, and then through Heat Policy or Net Zero reopeners if appropriate.

We think that full consideration should be given to competition in the delivery of large hydrogen projects, allowing the best capabilities, innovation and value for money solutions to come forward.

GDQ48. Do you have any other comments in relation to this section?

We suggest that Ofgem's work on a roadmap for development of hydrogen be informed by existing and emerging participants in the hydrogen supply chain as well as by network companies.

GDQ49. What are your views on our proposal to introduce a new domestic connections volume driver?

We agree a volume driver is appropriate rather than including connections in the baseline expenditure. We suggest this driver should also consider cost reductions for customer disconnections.

GDQ50. What are your views on our proposal to continue with the large loads re-opener?

GDQ51. Do you agree with our definition of a 'large load' to use for this re-opener?

We agree with this approach including the 1% revenue trigger threshold if connection costs can't be recovered from the connecting party.

GDQ52. Do you agree with our proposal to continue with a smart meter rollout re-opener?

We agree with this approach including the 1% revenue trigger threshold if additional, unavoidable costs due to smart metering are evidenced.

GDQ53. Do you agree with our proposal to continue with a common streetworks re-opener?

We agree with this approach including the 1% revenue trigger threshold if additional, unavoidable costs due to streetworks are evidenced.

10. GDN company-specific questions

<u>Outputs and incentives, including CVPs</u>

Ofgem has accepted a relatively small number of bespoke incentives in the area of customer service (and converted a few into common incentives); we support its reasoning in these cases. It has rejected many more and, in some cases, we think that this is reasonable to avoid overlaps with other, existing incentives or to avoid a proliferation of regulatory reporting in areas that do not necessarily push standards forward.

However, there were some examples where Ofgem seemed to accept that a customer need had been identified and that a proposed incentive had potential - but had rejected the ODI-R because the process of setting stretching targets was incomplete. Examples of this included Cadent's initiatives related to 'Establishing and raising the bar for all of our customer and stakeholder experiences', and its 'MOBs balanced scorecard'.

In cases like this, we think it would be positive to give companies the chance to complete this work before the Final Determinations. Assuming that any final targets set are stretching, we think that the special spotlight of an ODI-R could be merited in these cases.

a. Cadent

Outputs and incentives

Cadent Q1. Do you agree with our proposals on the bespoke ODIs? If not, please outline why.

Cadent Q2. What should the annual targets be for Cadent's high-rise building plans ODI-R and how can they be made sufficiently stretching?

Cadent Q3. Do you agree with our proposals on the bespoke PCDs? If not, please outline why.

Cadent Q4. Do you agree with our proposals on CVPs? If not, please outline why.

No further comment.

Uncertainty mechanisms

Cadent Q5. Do you agree with our proposals on the bespoke UMs? If not, please outline why.

We note that Ofgem has rejected most UMs on the basis that they are either included in common uncertainty mechanisms or the need case has not been made. We agree with this approach, including that the proposed Hydrogen projects e.g HyNet should be considered through NetZero/Heat reopeners or innovation funding.

A bespoke reopener is proposed for the London Medium Pressure project in central London which has experienced uncertainty on timing, scope and cost. We agree this project should be removed from the baseline funding and addressed through a reopener, if additional costs are justified.

Innovation

Cadent Q6. Do you agree with the level of proposed NIA funding for Cadent? If not, please outline why.

We agree with the approach Ofgem has taken to provide £32.5m of NIA funding and disallow £7.5m as BAU funding.

b. NGN

Outputs and incentives

NGNQ1. What are your views on the values for the common output parameters we have set out in the NGN Annex?

NGNQ2. Do you agree with our proposals on the bespoke ODIs? If not, please outline why.

NGNQ3. What are your views on our proposal to accept the Job completion lead-time including re-instatement ODI? Do you have a view on what the percentage performance target(s) should be and how is it stretching?

NGNQ4. Do you agree with our proposals on the bespoke LOs? If not, please outline why.

NGNQ5. Do you agree with our proposals on CVPs? If not, please outline why.

NGNQ6. Do you agree with our proposal to accept the CVP for Enhanced Repair for Gas Escapes?

No further comments

Uncertainty mechanisms

NGNQ7. What are your views on the baseline values for the Tier 2A iron mains volume driver?

The approach appears appropriate.

NGNQ8. Do you agree with our proposals on the bespoke UMs? If no, please outline why.

We note that Ofgem has rejected all UMs on the basis that they are either included in common uncertainty mechanisms or in PCDs. We agree with this approach.

Innovation

NGNQ9. Do you agree with the level of proposed NIA funding for NGN? If not, please outline why.

We agree with the approach Ofgem has taken to allow all of the NGN proposed funding.

c. SGN

Outputs and incentives

SGNQ1. Do you agree with our proposals on the bespoke ODIs? If not, please outline why.

SGNQ2. Do you agree with our proposals on the bespoke PCDs? If not, please outline why.

SGNQ3. Do you agree with our proposal for SGN's bespoke biomethane technology rollout PCD?

We see merit in the proposal but would prefer this funding to be across the whole of the GB networks so that the benefit is shared and there are opportunities for innovative capacity projects in all GDN areas.

SGNQ4. Should we include Kings Ferry within the Capital Projects PCD, rather than setting a separate PCD?

SGNQ5. Do you agree with our proposal for SGN's IP services reconfigurations PCD?

SGNQ6. Do you agree with our approach for SGN's Remote Pressure Management PCD?

SGNQ7. Do you agree with our proposals on CVPs? If not, please outline why.

No further comment.

Uncertainty mechanisms

SGNQ8. Do you agree with our proposals on the bespoke UMs? If not, please outline why.

We note that Ofgem has rejected all UMs on the basis that they are included in common uncertainty mechanisms or were not justified. We agree with this approach.

Innovation

SGNQ9. Do you agree with the level of proposed NIA funding for SGN? If not, please outline why.

We note that Ofgem allowed £30m of NIA funding out of a bid for £66m, disallowing expenditure that was business as usual. We support this approach.

d. WWU

Outputs and incentives

WWUQ1. What are your views on the values for the common output parameters we have set out in the WWU Annex?

WWUQ2. Do you agree with our proposals on the bespoke ODIs? If not, please outline why.

WWUQ3. Do you agree with our proposal on the bespoke PCD? If not, please outline why.

WWUQ4. Do you agree with our proposals on CVPs? If not, please outline why.

Uncertainty mechanisms

WWUQ5. What are your views on the baseline values for the Tier 2A iron mains volume driver?

The approach appears appropriate.

WWUQ6. Do you agree with our proposals on the bespoke UMs? If no, please outline why.

We note that Ofgem has rejected all UMs on the basis that they are included in common uncertainty mechanisms or were not justified. We agree with this approach.

Innovation

WWUQ7. Do you agree with the level of proposed NIA funding for WWU? If not, please outline why.

We agree with the approach Ofgem has taken to allow all of the WWU proposed funding.