

Date
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Jon Sharvill,
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Dear Jon,

Response to consultation on the closeout methodologies for RIIO-GD1

I am writing to respond to Ofgem's consultation on the proposed methodologies to close out the RIIO-GD1 price control which was published on 14 January 2022. As well as responding to Ofgem's proposed methodologies for closing out RIIO-GD1, this consultation also provides an opportunity to reflect and comment on the RIIO framework introduced for the first time for the RIIO-GD1 price control period.

The framework prescribed a set of principles, and hierarchy of mechanisms, which networks were required to work to, and set out very clearly what GDNs were funded to deliver. It also included incentives to ensure that companies delivered value in the areas most important to customers and stakeholders. This framework was instrumental and successful in shaping not only what companies delivered, but also how they delivered it.

At Cadent, we met all our eight-year primary outputs, with the exception of a couple of very specific areas where there were customer related COVID impacts which prevented us from carrying out certain types of work; and where we had agreed to other arrangements with Ofgem during the period due to specific regional factors. As such we very much share Ofgem's view that minimal action is required to close out RIIO-GD1 for Cadent.

For the two areas where the COVID pandemic meant we could not complete work to deliver our eight-year targets, there are already methodologies in place which require us to either catch up the work with no additional funding during RIIO-GD2 or adjust our revenues for the non-delivery. For the area where we had alternative arrangements in place, Ofgem have already confirmed the successful delivery of these regionally focussed measures.

During RIIO-GD1 we were also successful in responding to the incentives set by Ofgem and have delivered significant additional value for our customers across a wide range of areas including, but not limited to, customer service, environmental emissions and customer bill reductions.

Given the scale of outstanding areas and the established methodologies for closeout set out within the RIIO-GD1 framework, as stated earlier we agree with Ofgem that minimal action is required to close out RIIO-GD1 for Cadent. We are also keen to finalise closeout for RIIO-GD1 as soon as possible so that both GDNs and Ofgem can focus on:

- finalising the remaining outstanding elements of the RIIO-GD2 framework;
- delivering value for customers and stakeholders during RIIO-GD2;
- beginning preparations for RIIO-GD3; and

- 
- shaping the future of the gas network to deliver Net Zero.

These views have shaped our responses to the specific questions within the consultation document, which can be found along with some supporting commentary where relevant, in the appendix to this letter.

One area that we would highlight is our surprise that Ofgem's consultation on closing out the Network Output Measures (NOMs) element of the RII0-GD1 framework has not been brought forward to align with this consultation. Ofgem has already confirmed their 'minded to' position on NOMs in writing to the GDNs in November 2021. It is therefore important to note that our detailed responses to this consultation are predicated on Ofgem's 'minded to' position on NOMs.

We look forward to discussing the next steps in this process to close out RII0-GD1 with you. In the meantime, if there is anything that you would like to discuss further, please do not hesitate to contact me at stephen.hassall@cadentgas.com.

Yours sincerely

[By email]

Stephen Hassall

Head of Regulatory Operations



Appendix: Cadent responses to consultation questions

Approach to financial methodologies

Question 1: Do you agree with our proposed approach to financial methodologies?

Cadent Response

- We agree in principle with Ofgem's proposed approach to mechanical adjustments and the phasing of closeout adjustments.
- Where formulae are being amended, we would request that additional Ofgem assurance processes are put in place to ensure all closeout terms work as intended.
- We would also request that networks have flexibility in how they apportion adjustments across the remaining years of RIIO-GD2 so to try and best achieve a smoothed bill impact for customers.

Supporting commentary

Mechanical Adjustments for Close Out - We agree in principle. However, where formulae are being amended, e.g. to extend the use for LMOD beyond the period originally envisaged in the Legacy or RIIO-1 PCFM, then we request that Ofgem seek additional assurances via audit or similar process to ensure that the calculations and macros used to calculate the close out terms are working correctly.

To ensure that our understanding of the proposed methodology is correct we recommend using the PCFM working group to explore the detailed mechanics of amending the Legacy PCFMs.

Phasing of Close-Out adjustments - We agree in principle, however, some additional flexibility would be helpful.

If the ambition is to smooth the bill impact of close out on customers by spreading the cost over three years, then it might be preferable for networks to decide how to apportion the adjustment across the remaining years of RIIO-GD2 in a value neutral way.

As we understand LMOD will be adjusted based on RPI (via RRP tables as noted in figure 1), there will need to be a mechanism to true up to actual RPI in RIIO-GD3 which means that unfortunately this item will not be fully closed out until RIIO-GD3. This should not be a significant issue but needs to be considered for RIIO-GD3.

Iron mains risk reduction programme (Repex)

Question 2: Do you agree with our proposed methodology for the iron mains risk reduction programme?

Cadent Response

- We agree with Ofgem's assessment that no further adjustment to RIIO-GD1 allowances or RIIO-GD2 targets is required in relation to the iron mains risk reduction programme.
- We are unsure why Ofgem's consultation on closing out the related RIIO-GD1 Network Output Measures (NOMs) could not have been brought forward from May to align with this consultation. Ofgem confirmed their minded to position in writing to the GDNs in November 2021. This communication included a decision to set the RIIO-GD1 NOMs materiality threshold at +/-10% and confirmed that all GDNs were within this deadband so no further action was required. Our response to this consultation is predicated on this minded to position on NOMs.

Supporting commentary

During RIIO-GD1 GDNs' funding was tied to the delivery of licence obligations and primary outputs. For iron mains replacement GDNs were funded to deliver safety risk reduction and monetised risk. Ofgem lead the



move to this approach, which required GDNs to change how they operated, as it was believed that it would deliver greater safety and environmental benefits for customers than an input-based regime.

Ofgem included financial incentives within the RIIO-GD1 framework to ensure that GDNs delivered value in the key priority areas for customers whilst undertaking mains replacement activity. These incentives shaped what GDNs delivered during RIIO-GD1. Working to remove as much safety and environmental risk as possible, whilst driving down costs and increasing satisfaction for customers.

Cadent delivered, or exceeded, our funded iron mains replacement outputs in all of our network areas, over-delivering by up to 30% in some areas. This suggests that Ofgem's approach to RIIO-GD1 was successful in driving GDNs to remove more risk from the gas network than they were funded to deliver. This is further evidenced by the reduction in fracture volumes and gas in building events up to 50% beyond expected levels during RIIO-GD1, both of which have a direct link to customer safety.

It can also be seen that GDNs have delivered additional value for customers in key priority areas whilst delivering mains replacement works by responding to the incentives set by Ofgem within the RIIO-GD1 framework. By focusing on the riskiest mains, it accelerated the removal of safety and environmental risk from the network whilst still reducing costs for our customers and increasing their satisfaction.

During RIIO-GD1 GDNs faced challenges in delivering their iron mains replacement works, most notably the COVID-19 global pandemic. Cadent took an industry leadership role in managing the impact of COVID on our customers whilst supporting the communities we serve. In the spirit of the COVID-related easement letter received from Ofgem our focus throughout was on doing the right thing by our customers, colleagues and communities. This included:

- No use of the furlough scheme for Cadent employees.
- The provision of financial support to our supply chain, particularly through the first national lockdown period.
- Utilising any spare capacity to support the national / community COVID response (i.e. support in mobilising the NHS Nightingale Hospitals)
- Re-planning our works and redesigning our delivery methods to minimise close contact between colleagues and with our customers.
- Developing a Quantitative Risk Assessment, by working closely with the HSE and BEIS, that enabled us to be the first GDN to recommence mains replacement work (and which subsequently enabled the other GDNs to recommence work)

Despite the impact of COVID we still delivered our iron mains risk reduction primary output and NOMs that we were funded for. And in doing this we only marginally overspent against our plan for the year 2020/21 where the greatest impact of COVID was.

Fuel Poor Network Extension Scheme (FPNES)

Question 3: Do you agree with our proposed methodology for the FPNES?

Cadent Response

- We agree that undertaking legacy adjustments for over and under delivery during RIIO-GD1 is simpler than changing, or adding in additional, mechanisms within the RIIO-GD2 framework.
- We agree that the methodology set out in Special Condition 4J of the RIIO-GD1 licence should be used to make the adjustments for over-delivery.
- We support Ofgem's proposal to change the methodology set out in Special Condition 4J of the RIIO-GD1 to enable closeout, via legacy adjustments, for under-delivery. We agree that the proposal is still aligned to the 2015 FPNES policy intention.
- We agree that due to the challenges that GDNs faced during RIIO-GD1, including changes to the FPNES eligibility criteria and the impact of COVID, that all over and under delivery is justified.
- We agree that the allowance adjustment for over-delivery should be smoothed evenly across all eight years of RIIO-GD1.
- However, as all of our networks would have met their FPNES targets if it were not for COVID-19, the allowance adjustment for under-delivery should only be applied to the period where this pandemic



impacted our operations. For simplicity we propose all of the legacy adjustment should be made to the year 2020-21.

Supporting commentary

Through the Ofgem-led RIIO-GD1 closeout working groups, Cadent had identified an alternative option for closing out the RIIO-GD1 FPNES to try to fully maintain the policy intent of the 2015 FPNES methodology decision. However, this option required a number of changes to Special Condition 3.14 in the RIIO-GD2 licence including to the formulae, definitions and appendices. As such, we agree that Ofgem's proposed methodology set out in the consultation document offers a simpler solution to closing out the RIIO-GD1 FPNES.

Following our review of Ofgem's closeout proposals, the 2015 FPNES decision and the RIIO-GD1 licence we also believe that Ofgem's proposal regarding managing under delivery, whilst requiring a change to the RIIO-GD1 licence, is still aligned to the original policy intent and does not represent an ex-post change to the incentive properties of the scheme.

The RIIO-GD1 licence sets out that "where the Non Gas Fuel Poor Network Extension Scheme continues beyond 31 March 2021, the under-delivery shall be added to the relevant output commitment in the Second Price Control Period". As the FPNES has been changed to a capped volume driver for RIIO-GD2 (to manage future uncertainty), we agree that there is not a "relevant output commitment" to add the under delivery on to. So therefore, we support Ofgem's proposal to make a legacy adjustment.

When considering how the legacy adjustments for any under or over delivery should be applied across the RIIO-GD1 period the profile of our delivery must be considered to identify the appropriate approach.

During RIIO-GD1 we made good progress in the early years of the price control and were ahead of our targets in three of our four networks. However, the changes made by Ofgem in 2018 to the FPNES eligibility criteria presented a significant challenge and by 2019/20 our delivery was drastically reduced.

As such, we worked hard with our partners and stakeholders to develop an enhanced recovery plan which identified several large community schemes, implemented a number of new initiatives and leveraged all available third-party support to ensure that we would meet or marginally over-deliver against our targets.

However, the COVID-19 pandemic significantly impacted the delivery of our enhanced recovery plans in 2020-21 as we saw national and regional "lockdowns" preventing in-home works, scheme customers requesting postponements, local authorities deferring or cancelling schemes and third-party central heating installers furloughing staff.

As such, we support legacy adjustments for our over-delivery in our Eastern network (East of England) being applied evenly across the RIIO-GD1 period. However, given that it was COVID that stopped us from delivering our enhanced recovery plans in 2020-21 the legacy adjustment for under-delivery in our three other networks should be solely applied to this year.

Capacity utilisation

Question 4: Do you agree with our proposed methodology for capacity utilisation?

Cadent Response

- We agree with Ofgem's proposed methodology for closing out RIIO-GD1 capacity utilisation.
- The NOMs methodology was developed during RIIO-GD1 and incorporated asset utilisation into the monetised risk values derived through the application of the NOMs Methodology. Therefore, no separate assessment is required.
- We are unsure why Ofgem's consultation on closing out the RIIO-GD1 Network Output Measures (NOMs) could not have been brought forward from May to align with this consultation. Ofgem confirmed their minded to position in writing to the GDNs in November 2021. This communication included a decision to set the RIIO-GD1 NOMs materiality threshold at +/-10% and confirmed that all GDNs were within this deadband so no further action was required. Our response to this consultation is predicated on this minded to position on NOMs.



Reliability (Interruptions)

Question 5: Do you agree with our proposed methodology for the reliability output?

Cadent Response

- We agree with Ofgem's proposed methodology for the reliability output.

Shrinkage and Environmental Emissions Incentives

Question 6: Do you agree with our proposed methodology for the Shrinkage and Environmental Emissions Incentives?

Cadent Response

- We agree that there was no impact from COVID on average system pressure or gas conditioning levels during RIIO-GD1.
- Therefore, we agree that there should be no adjustment made to the methodology for closing out the RIIO-GD1 Shrinkage and Environmental Emissions incentives.
- Whilst we do not necessarily support an adjustment to RIIO-GD2 baseline values, we agree that any review of them or the RIIO-GD2 incentive, and potential subsequent consultation on them, should be undertaken separately to this RIIO-GD1 close out consultation.
- For the avoidance of doubt, under Ofgem's proposed methodology there should be no future statutory consultation to modify Special Conditions 7.10 and 7.11 as they relate solely to closing out the RIIO-GD1 Shrinkage and Environmental Emissions Incentives.

Supporting commentary

In the RIIO-GD2 Draft Determinations Ofgem expressed concerns that there could be impacts from COVID on average system pressure and gas conditioning in 2020-21 that could significantly impact the financial outcome of the Shrinkage and Environmental Emissions Incentives due to the importance of the final year within these mechanisms.

In our response to RIIO-GD2 Draft Determinations we set out that we did not envisage that there would any positive or negative impact on gas conditioning due to COVID and that we would need to wait until the end of the performance year, after the winter peak in demand, to understand if different patterns of gas use (for example increased daytime domestic use due to home working) would have an impact on average system pressures.

Like Ofgem, at the end of RIIO-GD1 we identified no observable impact on average system pressures or gas conditioning as a result of the COVID pandemic. At the highest level, we achieved a 26% reduction in Shrinkage across RIIO-GD1, of which 3% was in the final year so broadly in line with the annual average during the period.

Therefore, we agree that there should be no adjustment to the closeout methodologies set out in Special Conditions 7.10 or 7.11 of the RIIO-GD2 licence, nor the formulae and methodology set out in Special Condition 1F of the RIIO-GD1 licence.

Under Option B set out in this RIIO-GD1 closeout consultation Ofgem state (in para 7.12) that the RIIO-GD2 baseline is implemented in Special Condition 7.10. It is also stated that Special Conditions 7.10 and 7.11 of the RIIO-GD2 licence would need to be modified to implement any changes to the RIIO-GD2 baselines. For the avoidance of doubt there should be no modifications to Special Conditions 7.10 or 7.11 in the RIIO-GD2 licence as they relate solely to closing out the RIIO-GD1 incentives. The RIIO-GD2 Shrinkage Management incentive is implemented within Special Condition 4.4 (Part A) of the RIIO-GD2 licence, so therefore this is the condition that would need to be modified to implement any changes.

We are aware of some practical challenges with implementing the gas conditioning element of the RIIO-GD2 Shrinkage Management incentive. Therefore, if Ofgem are considering a future consultation on this incentive, as set out in this consultation, then this could provide an opportunity to reassess the overall structure of the

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incentive, given the implementation challenges, and consider how it supports the outputs from the COP26 summit.

Tax Clawback – WWU

Question 7: Do you agree with our minded-to position in respect of the pre RIIO-GD1 period, i.e., to correct the provisional adjustment and align the treatment of net interest on derivatives with the policy intent of the clawback mechanism as set out in the 2009 Open Letter? If not, please explain why.

No response

Question 8: As regards clawback during RIIO-GD1, which of options one and two do you consider to be more appropriate? Please explain why.

No response

Disposals

Question 9: Do you agree with our methodology for disposals?

Cadent Response

- We agree in principle with Ofgem's proposed methodology for disposals.
- However, we request that the detailed mechanics for how these adjustments will be made, through both the Legacy PCFM and RIIO-GD2 PCFM, are discussed further and finalised at a sector level well in advance of the November 2022 annual iteration process.