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Sent by email to: RIIOED2@ofgem.gov.uk

Dear Steven,

RIIO-ED2 Draft Determinations

Thank you for the opportunity to respond to the above consultation. This is a non-confidential response on behalf of the Centrica Group.

The proposals for the RIIO-ED2 price control aim to provide good value for money for consumers and effectively enable the distribution network operators (DNOs) to facilitate the legally binding Net Zero emissions targets. The proposals also aim to appropriately manage the uncertainties associated with the energy system transition. The proposals go some way to meeting these aims but should be improved in some areas. The financial proposals should also be reviewed to ensure RIIO-ED2 strikes a fair balance of risk and reward between consumers and the DNOs.

We highlight:

- **The allowed returns are already generous and do not need to be increased.**
- **The calibration of some incentive mechanisms should be strengthened.**
- **Arrangements relating to flexibility and the delivery of Distribution System Operation activities should be improved.**
- **Careful consideration should be given to whether regulatory intervention is necessary to manage the impact of high outturn inflation on real equity returns on consumers.**

The allowed returns are already generous and do not need to be increased:

Some input components for setting the value of allowed returns have been derived in ways that result in the allowed returns being needlessly generous. There is evidence of ‘aiming up’ when setting the point estimate for the cost of equity. ‘Aiming up’ occurred when setting allowances for equity issuance costs, which have been described as “even generous” by Ofgem¹. In other words, these allowances are considered to be inefficient. There is also evidence of Ofgem effectively

¹ Finance Annex paragraph 10.86.
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‘aiming up’ - by not making the necessary downward adjustments. The beta estimates were not reduced to reflect the reduced systematic risk. No weight was placed on the cross-checks on the output from the Capital Asset Pricing Model, which suggest point estimate for the cost of equity should be reduced². We estimate allowed revenues over the RIIO-ED2 period are £457m higher than needed simply because no weight was placed on the contemporaneous evidence provided by the cross-checks.

There is also evidence of ‘aiming up’ when setting debt allowances. ‘Aiming up’ occurred when setting allowances for the cost to carry – the point estimate was set at the upper limit of the range³. Again, there is evidence of Ofgem effectively ‘aiming up’ by not making the necessary downward adjustments. Debt allowances were not reduced to reflect the ‘halo effect’, which Ofgem estimates is now 175% of the value estimated when then the RIIO-2 transmission and gas distribution price controls were set in 2020⁴. We estimate allowed revenues over the RIIO-ED2 period are £143m higher than needed simply because of these instances of ‘aiming up’.

Along with allowed returns being higher than necessary, a mechanism that adjusts returns if there is systematic outperformance, thereby resulting in returns being higher than anticipated when the price control was set, has not been included. We recognise the Competition and Markets Authority (CMA) removed the outperformance wedge from the transmission and gas distribution price controls⁵. The wedge was removed for various reasons including that it was considered to be poorly targeted. However, the proposal to remove the wedge and not replace it with an appropriately designed mechanism is not consistent with the CMA’s decision. An improved form of the wedge, or any another type of mechanism, that addresses the concerns the CMA previously highlighted could be implemented. Among other things, this means the practical difficulties associated with mitigating for information asymmetry between Ofgem and the DNOs remain unresolved.

We also expect the Return Adjustment mechanism will provide limited protection against returns being higher than anticipated when the price control was set. For example, we estimate that the average DNO would need to achieve the maximum reward on all output delivery incentives and then under-spend expenditure allowances by 12% in order for the secondary threshold to be triggered. It is unlikely that such extreme outperformance would be considered to be in the normal range when the price control is set and that corrective action should not be taken before these returns are achieved. The proposed levels for the primary and secondary thresholds should be reviewed.

The calibration of some incentive mechanisms should be strengthened:

Some incentive mechanisms have been calibrated to ensure rewards are more proportionate to performance improvements. The proposed baseline target for the Customer Satisfaction Survey incentive reflects the most recent performance data⁶, which captures the progressively improving

² Finance Annex paragraph 3.83.

³ Finance Annex paragraph 2.28.

⁴ Finance Annex paragraph 2.15.

⁵ “Final determination Volume 2B: Joined Grounds B, C and D”; paragraph 6.18:

https://assets.publishing.service.gov.uk/media/617fd07ce90e07197483b8a9/ELMA_Final_Determination_Vol.2B.pdf.

⁶ Core Methodology paragraph 5.11.

performance over the RIIO-ED1 period. Also, the upside performance ‘deadband’⁷ should result in companies being rewarded only for further underlying performance improvements.

However, the calibration of other incentive mechanisms should be strengthened. For example, the proposed baseline target and the maximum penalty for the Complaints Metrics are based on performance that is now outdated and do not fully reflect the progressively improving performance over RIIO-ED1⁸. As a result, the DNOs are already performing ahead of the proposed target. The proposed target creates headroom that protects the DNOs from being penalised for some performance deterioration. As a general rule, Ofgem should always seek to use the latest data available to set targets. We estimate the value of the headroom to be worth £17m across RIIO-ED2.

There are similar concerns about the calibration of the Interruptions Incentive Scheme. Three main changes have been proposed for the way in which targets for unplanned Customer Minutes Lost metric are set⁹. We do not consider the case for the need for change has been made because the analysis of historical performance does not fully account for the impact of the cap on rewards on performance. The proposed changes individually and collectively soften the baseline targets for the entire sector with those DNO that have delivered comparatively poorer levels of performance receiving the greatest protection. We estimate the proposed changes provide the DNOs with protection worth £215m over the price control.

Arrangements relating to flexibility and the delivery of Distribution System Operation activities should be improved:

There are aspects of the proposals that need to be improved to allow the benefits that flexibility can provide to consumers to be fully realised. For example, the load-related volume drivers are intended to allow expenditure allowances to respond to changes in demand. However, the volumes drivers for investment on the secondary network exclude flexibility and will provide allowances only for network assets. This feature may encourage the DNOs to reinforce their network when deploying flexibility would be the efficient solution.

We also do not agree with the proposal to accept the majority of the Distribution System Operation (DSO) strategy proposals without amendment¹⁰. In our response to the Call for Evidence on the DNOs’ business plans, we highlighted how the proposals relating to the delivery of DSO functions needed to be improved in order to deliver consumer value. We also explained that the differences in approaches and in schedules will cause operational inefficiencies for market participants operating in multiple regions. Activities such as the development of flexibility markets that are needed to facilitate meeting Net Zero emissions targets could be negatively affected by the operational inefficiencies. We recognise DSO arrangements fall within the scope of the review of local energy institutions and governance currently being undertaken by Ofgem. Nevertheless, there are sensible steps that can be taken now that would not conflict with or pre-empt the outcomes of the review.

⁷ Core Methodology page 111.

⁸ The proposed baseline target and the maximum penalty are based on performance over the entire RIIO-ED1 period.

⁹ Core Methodology page 168.

¹⁰ Core Methodology paragraph 4.46.

We have similar concerns about the companies' connections strategies and their approaches to delivering connections. Also, we have experienced the negative impacts of the shortages of the relevant staff and skills, which have already become apparent during RIIO-ED1. At this stage, we are not sufficiently comforted that the aspects of the proposals will be effective to encourage the DNOs to deliver the necessary step-change in performance. Ofgem should ensure that the DNOs receive efficient levels of funding for the appropriate investments in capacity needed to improve service, including for resourcing connections delivery (teams and customer service) and for using automation where possible (e.g. self-service tools).

Careful consideration should be given to whether regulatory intervention is necessary to manage the impact of high outturn inflation on real equity returns on consumers:

Inflation plays an important role in the regulatory framework for network companies. For example, the regulatory asset values of the companies are indexed to out-turn inflation and there is also an impact of out-turn inflation on the allowed rates of return. The 'leveraging' effect of inflation means that out-turn inflation being higher or lower than the long-run assumption when the price control is set also results in returns being higher or lower.

We estimate that the 'leveraging' effect of inflation means consumers will be required to fund revenues that are £2.5bn (17% higher) over the RIIO-ED2 period if inflation remains elevated for the first few years of the price control and then returns to the long-run view thereafter.

In appendix 1, we summarise the ways in which the proposed settlement is generous, embeds outperformance or provides the DNOs with significant protection against downside risk. Answers to selected consultation questions are included in the other appendices. I hope you find this response helpful. Please contact me if you have any questions.

Yours sincerely,

Gregory Edwards
Network Regulation Manager
Centrica Regulatory Affairs & Policy

Appendix 1: Generosity in the proposed settlement

The areas in which the proposed settlement is generous, embeds outperformance or provide the DNOs with significant protection against downside risk are summarised in the table below.

Table 1: Areas of generosity

Area	Detail
Allowed return on equity	<ul style="list-style-type: none"> • when setting cost of debt allowances - 'aiming up' by selecting the upper limit of the range as the point estimate for the cost of carry when setting cost of debt allowances. • when setting cost of debt allowances - effectively 'aiming up' by not making a downward adjustment for the 'halo effect' when setting cost of debt allowances. • when setting cost of debt allowances - providing an infrequent issuer premium for those companies that do not need the premium because they can manage their debt portfolios on a Group basis. • when setting the cost of equity – effectively 'aiming up' by not making a downward adjustment to the CAPM cost of equity to reflect the evidence of the cross-checks. • when setting the cost of equity - providing allowances for equity issuance costs have been described as "even generous" by Ofgem. • when setting the cost of equity – effectively 'aiming up' by adopting the beta values set for the RIIO-2 transmission and gas distribution price controls which were already overstated. • when setting the cost of equity – effectively 'aiming up' by not making a downward adjustment to reflect that systematic risk has been reduced because of mechanisms introduced in RIIO-2. • when setting the allowed return on equity - effectively 'aiming up' by not adjusting for expected outperformance.
Returns	<ul style="list-style-type: none"> • when designing the Returns Adjustment Mechanism – setting trigger thresholds at levels that provide insufficient protection against systematic outperformance.
Complaints Metric	<ul style="list-style-type: none"> • when setting the baseline target – embedding headroom by setting the target below current levels of performance. • when setting the maximum penalty – selecting a value attributable to an 'outlier' DNO and which does not reflect recent performance. • when setting the incentive strength – effectively reducing the incentive strength by setting an unnecessarily wide penalty range.
Interruptions Incentive Scheme	<ul style="list-style-type: none"> • when setting targets – softening the targets by removing the ratchet. • when setting targets for unplanned CMLs – softening the targets by reducing the annual improvement needed to avoid penalties. • when setting targets for unplanned CMLs - softening the targets by abandoning the approach based on an industry benchmark.
Other	<ul style="list-style-type: none"> • when developing the treatment of asset health expenditure – by not setting targets or outputs for expenditure on assets that fall outside the scope of the Network Asset Risk Metric. • when developing the treatment of expenditure allowances for Worst Served Customers – by choosing not to claw back allowances if they are not used for the purpose for which funding was provided. • When developing the treatment of expenditure for severe weather 1-in-20 events – by assuming all expenditure occurred will be efficient.

Appendix 2: answers to the consultation questions – Overview

Adjusting allowances for uncertainty:

Q2 What are your views on our two proposed options, and do you agree with our preferred option of a DRS?

Funding Provider of Last Resort (PoLR) activities by a directly remunerated services (DRS) mechanism is reasonable. Although funding via a DRS mechanism implies PoLR activities are deemed ‘de minimis’, we recommend that efficiency assessments be conducted and costs that are considered to be inefficient should be disallowed.

Q3 Do you agree with our proposal to introduce a re-opener to deal with recommendations from the Storm Arwen review, our proposed trigger and re-opener window?

We agree with the proposal to introduce this re-opener.

The Energy Emergencies Executive Committee identified several recommendations in areas including network resilience, restoration, customer communication and customer welfare¹¹. The RIIO-ED2 price control includes incentives (such as the Interruptions Incentive Scheme, the Consumer Vulnerability Incentive and the Customer Satisfaction Survey) that overlap in scope with some of the recommendations relevant to DNOs. Implementation of the recommendations may result in performance improvements, which do not appear to have been accounted for in the proposed targets for the relevant incentives.

We recommend that targets for the relevant incentives are tightened at Final Determinations to avoid performance improvements accruing to the DNOs simply as a result of implementing the Storm Arwen recommendations.

RIIO-ED2 in the round, post appeals review and pre-action correspondence:

Q10 Do you have any views on the proposed scope of the FDQ process and pre-action correspondence, including on the proposed timing for sending such to Ofgem?

The Final Determinations questions (FDQ) process as described in the consultation – to allow licensees to ask clarification questions and to notify Ofgem of any errors – may result in focus being placed on the correction of those errors that disbenefit the DNOs. The FDQ process should be expanded, or a parallel process designed, so that similar focus is placed on the correction of those errors that disbenefit consumers.

¹¹ See:

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1081116/storm-arwen-review-final-report.pdf.

Networks for Net Zero:

Core-Q4 Do you agree with our proposed secondary reinforcement volume driver and LV services volume driver and the associated controls?

In principle, we support the use of the proposed volume drivers and the associated controls. However, there are areas in which the design of these mechanisms can be improved:

- The volume drivers should be revised to allow funding for flexibility services to be provided and to complement other aspects of the price control meant to promote the use of flexibility such as the relevant licence conditions and the Distribution System Operation (DSO) incentive.
- The controls on funding adjustments via the volume drivers appear open to ‘gaming’ and, so, should be reviewed.

Core-Q5 Do you agree with our proposed LRE re-opener?

We agree with the proposal.

Supporting a smarter, more flexible, digitally enabled energy system:

Core-Q17 Do you agree with our proposal for implementing a Digitalisation Licence Obligation?

We agree that a Digitalisation Licence Obligation as described in the consultation should be implemented.

Core-Q18 Do you agree with our proposal to have staggered publications of Digitalisation Strategies between RIIO-ED2 and RIIO-2 licensees?

We agree that publication of the Strategies should be staggered.

Core-Q20 Do you agree with the proposed enhanced reporting framework associated with IT/OT Data and Digitalisation spend and DSAP investment proposals?

We support the proposed framework being implemented, especially because of the scale of the expected investment in IT infrastructure in RIIO-ED2. The framework should make it easier to assess whether the expenditure represents value for money for consumers and for the DNOs to identify efficiencies, including efficiencies that could be realised by the DNOs cooperating when developing IT infrastructure.

Core-Q24 Do you agree with our proposed design of the DSO incentive?

We agree with an incentive on DSO activities being introduced and we think the component parts (Stakeholder Survey, Performance Panel assessment and out-turn metrics) are appropriate. We recognise the difficulties associated with identifying appropriate out-turn metrics and developing robust baseline targets. We, therefore, support the DSO incentive being weighted towards the Stakeholder Survey and the Performance Panel assessment until there is greater confidence that the appropriate out-turn metrics have been identified and also in the target-setting methodologies.

We do not agree with the proposal to accept the majority of the DSO strategy proposals without amendment¹². In our response to the Call for Evidence on the DNOs' business plans, we highlighted how the proposals relating to the delivery of DSO functions needed to be improved in order to deliver consumer value. We also explained that the differences in approaches and in schedules will cause operational inefficiencies for market participants operating in multiple regions. Activities such as the development of flexibility markets that are needed to facilitate meeting Net Zero emissions targets could be negatively affected by the operational inefficiencies.

DSO arrangements fall within scope of the review of local energy institutions and governance currently being undertaken by Ofgem¹³. The review will not be completed in time to allow the findings to be incorporated into this price control review. Nevertheless, there are sensible steps that can be taken now that would not conflict with or pre-empt the outcomes of the review. These steps include requiring the relevant DNOs to ensure that their DSO IT infrastructure isn't tightly integrated into the rest of their IT estate, to avoid unnecessary costs being incurred if separation in the future is necessary.

Managing conflicts of interest:

The relevant DNOs should be required to strengthen their approaches to managing conflicts of interest given that Ofgem identified their strategies could result in barriers to third-party participation in markets being created. We are less confident that the financial incentive will be sufficiently effective in encouraging the DNOs to strengthen their approaches to managing conflicts of interest because:

- managing conflicts of interest is just one of several activities involved in the delivery of DSO functions and it is unclear how the incentive could encourage DNOs to prioritise managing conflicts of interest;
- in isolation, the proposed exposure of $\pm 0.2\%$ of return on regulatory equity (RoRE) may not be strong enough to deliver the improvements needed; and
- some features that could give rise to the risk of conflicts of interest, such as how network planning will be delivered, are structurally embedded in some DSO strategies.

This is another area in which Ofgem should require the relevant DNOs to improve their DSO strategy proposals.

Stakeholder survey:

The questions that have been proposed for inclusion in the survey are appropriate. It is unclear whether stakeholders will still be able to provide 'freeform' comments when being surveyed. We continue to recommend that the survey captures 'freeform' comments, in order to increase the richness of the responses that scores are not able to provide.

¹² Core Methodology paragraph 4.46.

¹³ See: <https://www.ofgem.gov.uk/publications/call-input-future-local-energy-institutions-and-governance>.

Performance Panel assessments:

The high-level framework described in the consultation is reasonable. The framework is still being developed and will be consulted on ahead of Final Determinations. We will provide feedback on the guidance that is still being developed in our response to that consultation. A key issue to be resolved is how the performance of those DNOs that proposed ambitious plans and the performance of those DNOs that proposed less ambitious plans can be measured in an equitable way. It is also necessary to consider both performance against set criteria and performance relative to the commitments made in the DSO strategies.

Core-Q25 What are your views on the outturn performance metrics and RRE we are proposing to include in the DSO incentive? If you do not support their inclusion, please outline which alternative outturn performance metric(s) or RRE you think should be included in the framework instead.

The performance metrics and regularly reported evidence are still being developed and will be consulted on ahead of Final Determinations. We will provide feedback on the proposals that are still being developed in our response to that consultation.

Core-Q26 Do you agree with our proposal for the DSO re-opener?

We agree with the proposal.

Core-Q27 Do you agree with our proposal to introduce a new whole system strategic planning Licence Obligation?

We support the proposal to introduce this obligation. The proposal complements the existing “whole electricity system” licence condition¹⁴ by requiring DNOs to deliver wider whole system benefits other than those relating to the electricity system.

Core-Q28 What are your views on the digital tools that could be used to support this?

All registers should be published. At a minimum, the tools should deliver greater visibility to network users and project developers on the system connections challenges impacting them, including more granular visibility of the progress being made to deliver a solution (with forecast timings for completion).

¹⁴ Standard Licence condition 7A.
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Meet the needs of consumers and network users:

Core-Q29 Do you agree with our proposed target and thresholds for the deadband, maximum reward and penalty?

Core-Q30 Do you agree with our proposed approach to working with DNOs to implement Storm Arwen actions related to customer satisfaction?

The proposed target, deadbands, maximum reward and penalty are reasonable given the levels of performance achieved during RIIO-ED1. At this stage, we are less confident that the baseline target and/or deadbands will not need to be revised because of implementing the Storm Arwen actions. The implementation of the Storm Arwen recommendations could result in performance improvements during RIIO-ED2 that are consequential to implementation rather than wholly due to the DNOs' efforts. We recommend the target and/or deadbands are reviewed to avoid potential windfalls accruing to the DNOs.

Core-Q31 Do you agree with our proposed target and maximum penalty score?

We do not agree with the proposed target and maximum penalty score. Neither reflects the approach set out in the Sector Specific Methodology Decision (SSMD)¹⁵. The combination of the proposed target and maximum penalty score create the risk that there may be a perverse incentive to allow performance to deteriorate. Both the proposed target and maximum penalty score significantly protect the DNOs. We provide further detail below.

Target:

The proposed target of 2.8 is based on performance over the entire RIIO-ED1 period (data are available for six years) instead of the most recent years (e.g. the most recent four years). Sectoral performance improved from 4.61 in 2015-16 to 1.95 in 2021 (see Figure 1). The sector has consistently exceeded the proposed target since 2018-19. Additionally, the DNO that has been the poorest performer in five of the six years for which data are available (NPGN) has also achieved performance that is better than the target. It is clear that the proposed target does not embed the performance gains the DNOs have achieved.

The proposed target will allow the sector as a whole, or 12 of the 14 DNOs, to reduce performance relative to their most recent four-year average without incurring penalties. The proposed target provides the DNOs with headroom that is as high as 130% of their most recent four-year average performance, which is worth £3.3m annually. We, therefore, disagree that using data over the entire RIIO-ED1 period to set the target score will allow the improved performance that customers have experienced in RIIO-ED1 to be embedded into a BAU level of service. It is also unclear whether there are differences between the proposed targets and the levels of performance that the DNOs assume they will be able to deliver using baseline allowances. The proposed calibration of this incentive provides systematic protection against performance below target and mitigates the financial impact of a penalty if performance below target occurs.

¹⁵ The approach was stated to be that targets and maximum penalty scores should reflect RIIO-ED1 performance improvements by applying fixed targets using industry average performance data over the most recent years of RIIO-ED1. See page 25 of:
https://www.ofgem.gov.uk/sites/default/files/docs/2020/12/riio_ed2_ssmd_annex_1_delivering_value_for_money_services_for_customers.pdf.

Figure 1: Complaints Metric performance during RIIO-ED1

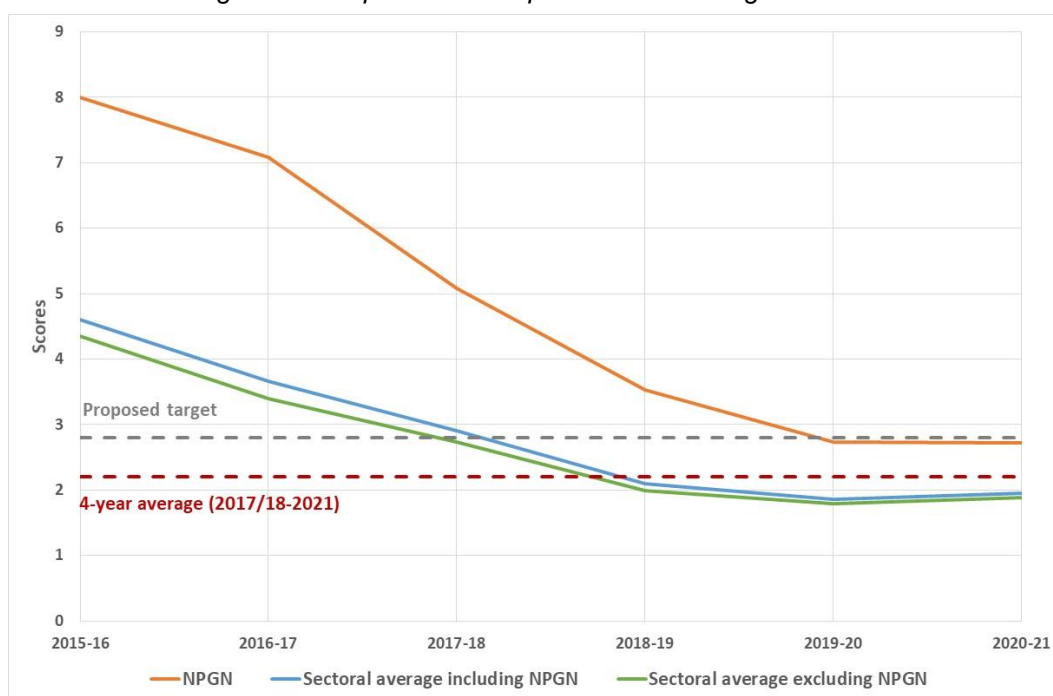


Table 2: Headroom embedded in the proposed target for the Complaints Metric

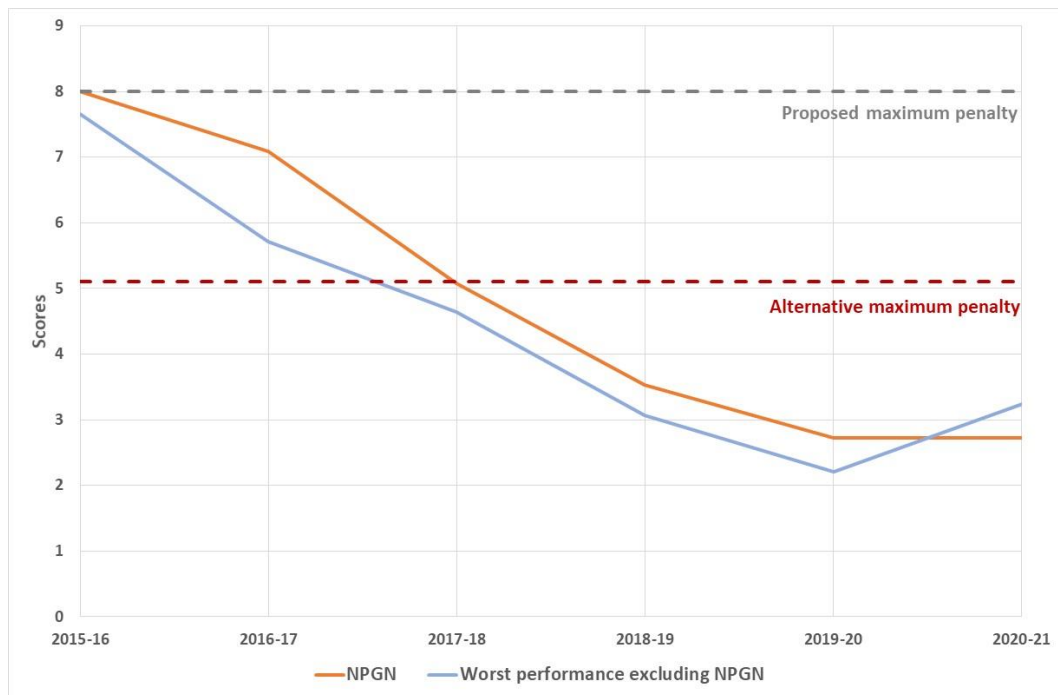
	Average performance over 2017-18 to 2020-21	Headroom provided by setting target at 2.8	Headroom as a percentage of performance over 2017-18 to 2020-21	Annual value of headroom provided by setting target at 2.8 (£m)
ENWL	2.0	0.8	40%	0.3
NPGN	3.5	0.0	0%	0.0
NPGY	3.1	0.0	0%	0.0
WMID	1.2	1.6	130%	0.7
EMID	1.2	1.6	132%	0.7
SWALES	2.3	0.5	22%	0.1
SWEST	2.0	0.8	38%	0.3
LPN	2.7	0.1	3%	0.0
SPN	2.6	0.2	6%	0.1
EPN	2.4	0.4	15%	0.2
SPD	1.6	1.2	70%	0.4
SPMW	1.8	1.0	52%	0.4
SSEH	1.8	1.0	59%	0.3
SSES	2.5	0.3	13%	0.2
Sector	2.2	0.6	27%	3.3

Maximum penalty:

The proposed maximum penalty of 8.0 is also based on performance over the entire RIIO-ED1 period instead of the most recent years (e.g. the most recent four years). Although the worst individual performance steadily improved over RIIO-ED1, the proposed maximum penalty has been set at the worst performance ever in RIIO-ED1, which occurred during the first year of the price control. As shown in Figure 2, the DNO (NPGN) that was the poorest performer in 2015-16 was also the poorest performer in the other four of the five years for which data are available. We question whether it is appropriate to base the maximum penalty on the DNO that has consistently been an outlier during RIIO-ED1 and on a single data point that will be eight years old at the start of RIIO-ED2.

We do not agree that the proposed maximum penalty of 8.0 will embed the performance improvements in RIIO-ED1 and will prevent DNO performance from deteriorating in RIIO-ED2 given no DNO has delivered performance worse than 5.1 from 2016-17 onwards. Furthermore, it is unclear why it is assumed the proposed maximum penalty can achieve these objectives. The primary purpose of a maximum penalty is to limit the financial penalty arising out of deterioration in performance instead of preventing deterioration in the first instance. The proposed maximum penalty also cannot embed performance improvements in RIIO-ED1 because, by any measure, it does not reflect the improvements achieved.

Figure 2: Complaints Metric worst annual performance during RIIO-ED1



The proposed maximum penalty may have the opposite effect to that intended, by mitigating the financial impact of a penalty. The incentive strength is about 0.04% of RoRE per point, based on the proposed target of 2.8 and the maximum penalty of 8.0. The incentive strength is watered down by the proposed maximum penalty being set at an unnecessarily high level of 8.0. The incentive strength increases to 0.09% of RoRE per point if the proposed maximum penalty is set at 5.1, which is the worst individual performance during the most recent four years. This means that the DNOs will benefit by being penalised about 0.05% of RoRE per point less if a penalty is levied simply because of the unnecessarily high maximum penalty. Further, as shown in Table 3, the sector is provided with protection valued at about £13m annually by the maximum penalty not being set at 5.1.

Table 3: Value of protection provided by the proposed maximum penalty

	Penalty if maximum score is set at 5.1 (£m)	Penalty for a score of 5.1 with maximum score of 8.0 (£m)	Annual value of protection provided by setting maximum score at 8.0 (£m)
ENWL	1.8	0.8	1.0
NPGN	1.3	0.6	0.7
NPGY	1.7	0.7	1.0
WMID	2.2	0.9	1.3
EMID	2.3	1.0	1.3
SWALES	1.1	0.5	0.6
SWEST	1.7	0.7	1.0
LPN	1.5	0.6	0.9
SPN	1.6	0.7	0.9
EPN	2.4	1.0	1.4
SPD	1.7	0.7	1.0
SPMW	1.9	0.8	1.1
SSEH	1.2	0.5	0.7
SSES	2.3	1.0	1.3
Sector	22.4	9.7	12.7

Core-Q39 Do you agree with our proposed design of the Major Connections incentive?

We agree with the incentive being comprise of the following three elements:

- Major Connections Customer Satisfaction Survey (MCCSS);
- Major Connections Annual Report; and
- reputational reporting.

Particularly, we welcome non-contestable services in relevant market segments (RMS) and in non-RMS being included within the scope of the MCCSS. We previously highlighted¹⁶ that we continue to experience difficulties with non-contestable services being delivered satisfactorily or in a timely manner. Allowing stakeholders to provide direct feedback on this key aspect of the connections process may lead to service improvements.

We continue to be concerned about the differences in the Major Connections strategies. In our response to the Call for Evidence on the DNOs' business plans, we highlighted how the proposals relating to the delivery of connections needed to be improved in order to deliver consumer value. We also explained that the differences in approaches and in schedules will cause operational inefficiencies for market participants operating in multiple regions. Activities such as the development of flexibility markets that are needed to facilitate meeting Net Zero emissions targets could be negatively affected by the operational inefficiencies.

Core-Q40 Do you agree with our proposed approach to target setting and applying the penalty?

At this stage, it is unclear whether the proposed approach is appropriate. Firstly, as noted in the consultation, the connection strategies are of varying quality. We, therefore, question whether the

¹⁶ For example, in our responses to the Incentive of Connections Engagement.
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mean average of the proposed scores represents a sufficiently challenging baseline. Secondly, the extent to which scores will be weighted based on stakeholders' experiences of the delivery of non-contestable services has not been made clear.

Core-Q41 Do you agree with our proposal to require reputational reporting of timeliness metrics for all RMS?

We agree with this proposal.

Core-Q42 Do you agree with our proposal to launch a wider review of the Connections GSoP (that is, beyond updating the payment amounts for inflation and incorporating standards for DG customers)?

We agree with the proposal. It may be necessary to introduce formal service level agreements.

Core-Q43 Do you have any views on what else could be done to help speed up connections to the distribution network and or develop a standard for the overall (ie, end to end) time to connect?

DNOs need to address the shortages of the relevant staff and skills, which have already become apparent during RIIO-ED1. The shortages have negatively impacted response times and, in some instances, the quality of quotes. Some consumers have experienced long delays and have received poor information on progress where there is a need for even relatively minor works. DNOs should also optimise the use of self-service tools to speed up the connections process.

Maintain a safe, resilient and reliable network:

Core-Q46 What are your views on moving to an asymmetric cap and collar?

We think that, compared to setting rolling targets, reducing the upside risk is a less effective way of protecting against potential systematic outperformance.

Core-Q47 Are there alternatives to reducing the revenue cap that you think would better balance increases in reliability and the cost to consumers than reducing the revenue cap?

We think that setting rolling targets would better balance increases in reliability and the cost to consumers. An advantage of rolling targets is that performance that is revealed during the price control is used to set targets in subsequent years of the same price control. The corrective nature of rolling targets reduces the risk of extended systematic outperformance that could result from targets fixed at the outset of RIIO-ED2 being insufficiently challenging. Setting rolling targets would also address the National Audit Office's finding that targets in RIIO-ED1 were fixed too far in advance¹⁷. We provide further detail in our response to question Core-Q48.

¹⁷ See page 3 of: <https://www.nao.org.uk/wp-content/uploads/2020/01/Electricity-networks.pdf>.
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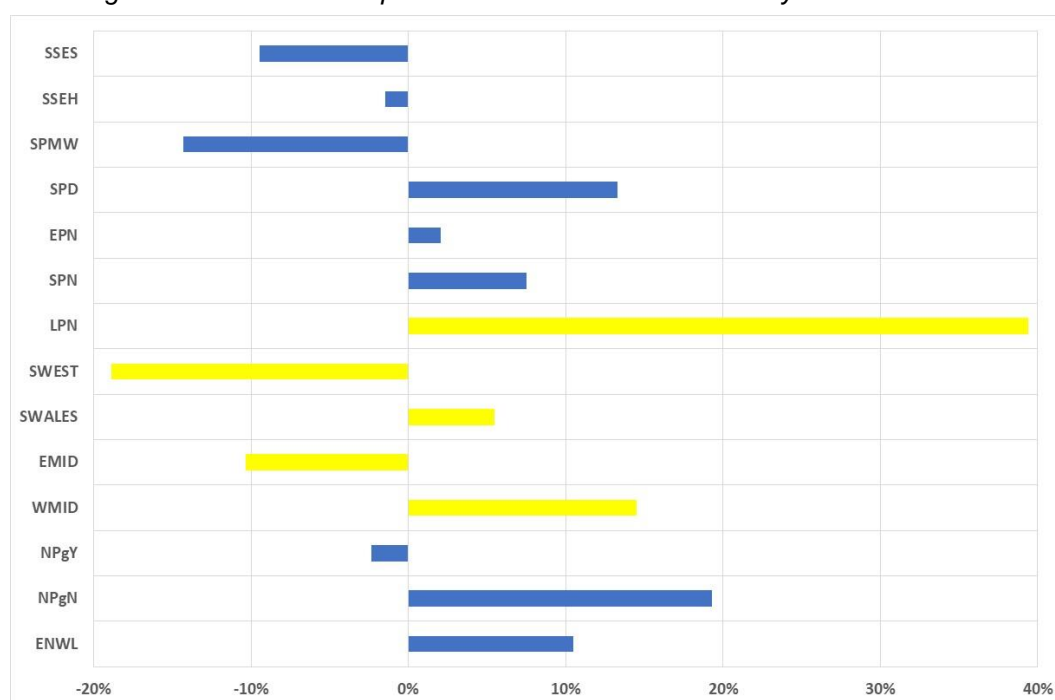
Core-Q48 Do you agree with how we have characterised the operation of the current CML methodology and our reasons for changing to setting targets in line with our CI methodology?

We do not think that the impacts of the relevant factors that may have affected performance in RIIO-ED1 have been fully considered and, so, the operation of the current Customer Minutes Lost (CMLs) methodology has not been appropriately characterised. We, therefore, do not think the proposal to change setting targets in line with the Customer Interruptions (CI) methodology has been justified. Also, the protection offered to the DNOs by the targets being softened has not been demonstrated to be in consumers' interests.

Performance in RIIO-ED1:

In the consultation, it is suggested that the ability for the DNOs to consistently make improvements has begun to taper off because actual annual improvements have generally been lower than in previous price controls and there has been greater year-on-year volatility¹⁸. Performance during the first six years of RIIO-ED1 has been mixed: eight DNOs have achieved improvements relative to their position at the start of RIIO-ED1 while the remaining six have not (see Figure 3). Overall, sectoral unplanned CMLs reduced by 4% over the period¹⁹.

Figure 3: Reduction in unplanned CMLs across the first six years of RIIO-ED1



* Companies shaded in yellow are the frontier companies, which would have set the benchmark for the sector according to the methodology set out at SSMD.

There are several factors that can affect performance and that influence year-on-year volatility. However, the performance data presented in the consultation have not been normalised as far as is possible to take account of these factors even though the impact on performance has been

¹⁸ Core Methodology paragraph 6.12.

¹⁹ Weighted by customer numbers.

recognised. For example, in the *2016-17 RIIO-ED1 Annual Report*, Ofgem referred to the impact of weather on performance²⁰. Alternatively, including data on the factors that affect performance would have provided important context for interpreting the performance data presented in the consultation.

Nevertheless, we think a key factor that may have affected performance and contributed to the observed tapering in improvements is the combination of the introduction of a cap of 2.5% of RoRE on rewards available via the Interruptions Incentive Scheme (IIS) in RIIO-ED1 and DNOs performing ahead of targets before the start of RIIO-ED1. Rewards were not limited in prior price controls. The cap on rewards can affect company behaviour in various ways. For example, a company may curtail investment aimed at further improving performance if it expected to earn rewards at or near the cap without the additional investment. As a result, the cap effectively acts as a limit on performance improvements by setting a spending envelope and could have contributed to the observed tapering in improvements. The potential impact of the cap is compounded by the fact that DNOs were already performing ahead of targets before the start of RIIO-ED1. The outperformance embedded in the RIIO-ED1 targets further reduced the scope for improvement within the cap.

DNOs receiving rewards at or near the cap has been observed throughout RIIO-ED1. For example, in the *2016-17 RIIO-ED1 Annual Report* (for the second year of RIIO-ED1), Ofgem stated:

Based on performance against targets in 2016-17, DNOs will earn £159.7m under the IIS. This compares with £163.9m in 2015-16. In both years, a number of DNOs reached the cap on the rewards that can be earned under the IIS; we introduced a cap at the beginning of RIIO-ED1 so that customers are not exposed to excessive DNO rewards²¹.

Also, in relation to the third year of RIIO-ED1, Ofgem stated:

Based on performance against targets, DNOs earned £138m in 2017-18; this compares with £166m in 2016-17. This year, three DNOs reached the cap on revenue that can be earned under the IIS; the number of DNOs reaching this cap is lower than in previous years²².

Rewards at or near the cap are not confined to the earlier years of RIIO-ED1; this has continued throughout. We refer to UKPN as an example. The performance for UKPN's three regions over the first six years of RIIO-ED1 is shown in Figure 4. Unplanned CMLs in the LPN region reduced by 39% over the period (LPN is a 'frontier' DNO) while performance in the SPN and EPN regions reduced by only 7% and 2% respectively. Despite the overall reductions, performance in the SPN region deteriorated a little between 2019-20 and 2020-21.

As shown in Table 4, SPN received 76% of the rewards available in 2020-21 despite performance deteriorating. For comparison, SPN received 75% in 2019-20 even though performance relative to the previous year improved. Performance in the EPN region either remained static or

²⁰ Paragraph 2.8 states: "We have, however, seen performance slightly deteriorate in the second year compared to the first for many DNOs. This is largely due to poorer weather conditions, including storms. DNOs' targets also get tighter over time, meaning they must continue to make improvements in order to continue earning rewards under the incentive". See: <https://www.ofgem.gov.uk/publications/riio-electricity-distribution-annual-report-2016-17>.

²¹ Paragraph 2.9.

²² "2017-18 RIIO-ED1 Annual Report"; paragraph A2.3: <https://www.ofgem.gov.uk/publications/riio-electricity-distribution-annual-report-2017-18>.

deteriorated between 2018-19 and 2020-21 but EPN received no less than 98% of the rewards available over the same period.

Figure 4: Unplanned CMLs for UKPN's regions across the first six years of RIIO-ED1

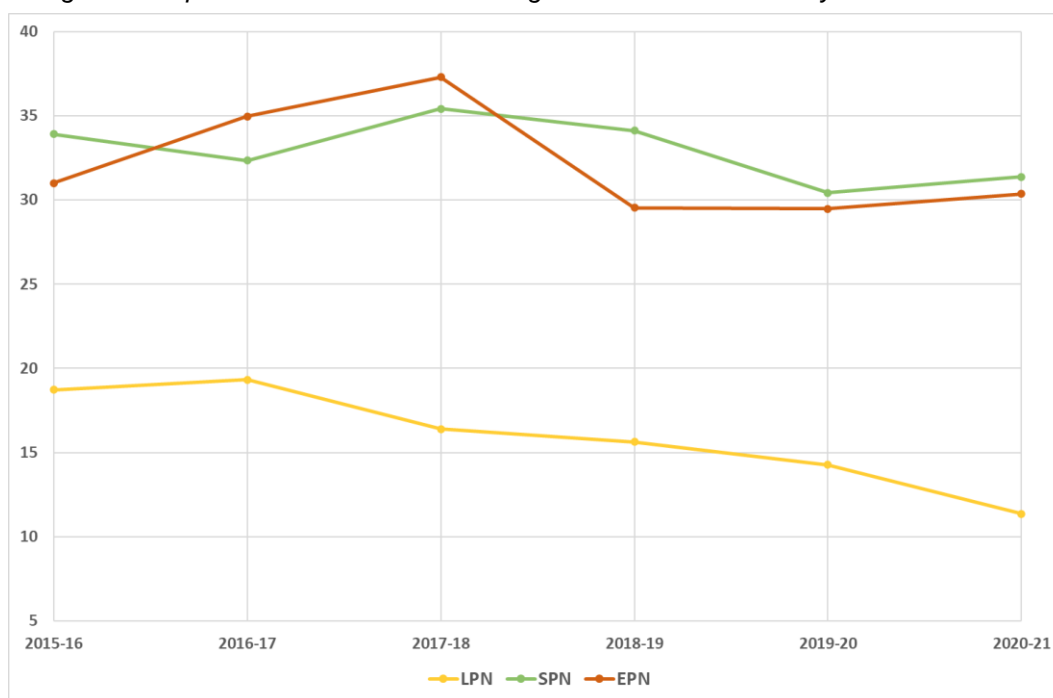


Table 4 Percentage of maximum IIS reward earned by UKPN in 2018-19 – 2020-21²³

	2018-19	2019-20	2020-21
LPN	100%	99%	99%
SPN	66%	75%	76%
EPN	100%	98%	99%

Based on the above analysis, we do not think it can be reliably inferred that the opportunities to make improvements are reducing. We expect that the combination of the cap on rewards and DNOs performing ahead of targets before the start of RIIO-ED1 will have affected company behaviour and, by extension, performance. We, therefore, do not think that the operation of the current CMLs methodology has been appropriately characterised.

Target-setting methodology changes:

The methodological changes relevant to setting targets for unplanned CMLs are:

- Ratchet: it was previously decided to apply a ratchet, to address the risk of DNOs starting RIIO-ED2 ahead of their 2023/24 targets. It is now proposed that the ratchet is removed.
- Use of frontier performance to set an industry benchmark: it was previously decided to require DNOs to converge towards the industry benchmark. It has now been decided to set targets reflecting each DNO's recent performance.
- Improvement factors: it was previously decided to embed annual improvement of 1.5% in the targets for frontier companies and 3% for companies not at the frontier. It is now proposed that the annual improvements to be embedded are halved.

²³ Data were obtained from UKPN's Regulatory Financial Performance Reports available at: <https://www.ukpowernetworks.co.uk/about-us/regulatory-information>.

Each individual change softens the targets. We do not comment on the proposal to not apply the ratchet. However, we note it is one of a number of proposals that, in isolation, appear less significant but cumulatively result in the proposed settlement systematically favouring the DNOs. As we explained above, we do not think changes to the target-setting methodology have been justified because we do not think it can be reliably inferred that the ability for the DNOs to consistently make improvements has begun to taper off.

It can be inferred that a driver to change the target-setting methodology is that some DNOs would start RIIO-ED2 in a penalty position²⁴. If so, we disagree. In principle, there is no reason why targets need to be set so as to avoid any DNO starting RIIO-ED2 in a penalty position. The incentive properties remain regardless – the marginal incentive to improve to incur a smaller penalty or earn a larger reward is the same. In any event, the sector as a whole is currently performing slightly ahead of target for the first year of RIIO-ED2 (30.6 CMLs compared to 30.9 CMLs)²⁵.

It has also been suggested that the cost of delivering performance improvements is increasing and the current incentive rates limit the improvements that can be made²⁶. However, no evidence has been presented in the consultation, of the publicly available versions of the companies' business plans that support this claim. This is an area of the price control review in which the information asymmetry between the DNOs and Ofgem is particularly problematic.

Use of frontier performance to set an industry benchmark:

The use of frontier performance to set an industry benchmark was designed to require all DNOs to converge towards the industry benchmark on the basis that consumers should receive similar levels of service regardless of location. Adopting the proposed company-specific approach (in which convergence is no longer required) is a fundamental change. The change has not been justified and it has not been explained whether it is desirable or appropriate to embed the principle that service levels vary by location in the target-setting methodology. It also has not been explained whether the levels that will be embedded provide a good level of service to consumers. This proposed change appears perverse because the companies that would have been required to deliver the biggest improvements to converge towards the sector benchmark under the previous methodology are now offered the greatest protection.

Improvement factors:

It is now proposed that the improvement factors are halved to, an annual improvement of 0.5% for frontier companies and 1.5% for companies not at the frontier. This is a significant weakening of the annual improvement to be embedded in the targets, especially for the frontier companies. As shown in Table 5, the frontier companies will be required to deliver about a quarter of the improvement previously anticipated in order to avoid penalties.

In the consultation, it is explained the improvement factors have been reduced in order to be consistent with those for CI targets. We disagree with the approach. Consistency should not be maintained simply for the sake of doing so; proposals should be robustly justified. Further, we think the reduced improvement factors increase the risk of systematic outperformance.

²⁴ Core Methodology paragraph 6.53.

²⁵ Weighted by customer numbers.

²⁶ Core Methodology paragraph 6.24.

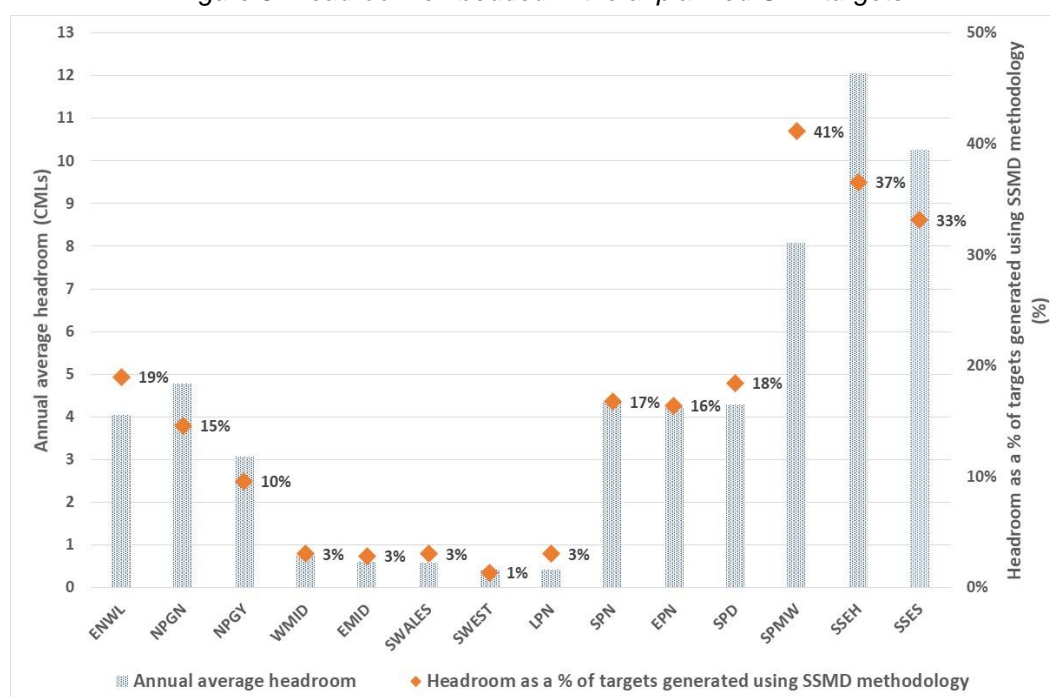
Table 5: Improvement embedded in the unplanned CML targets

DNO	Improvement required over RIIO-ED2 by the original improvement factors	Improvement required over RIIO-ED2 by the revised improvement factors	Variance	Revised improvement as a percentage of original improvement
ENWL	7.0%	5.9%	1.2%	83%
NPGN	7.4%	5.9%	1.5%	79%
NPGY	7.5%	4.9%	2.6%	66%
WMID	7.8%	2.0%	5.8%	26%
EMID	7.8%	2.0%	5.8%	26%
SWALES	7.8%	2.0%	5.8%	26%
SWEST	7.8%	2.0%	5.8%	26%
LPN	7.8%	2.0%	5.8%	26%
SPN	8.4%	5.9%	2.6%	70%
EPN	7.9%	5.9%	2.1%	74%
SPD	8.2%	5.9%	2.4%	71%
SPMW	8.4%	5.9%	2.5%	70%
SSEH	8.7%	5.9%	2.8%	67%
SSES	7.1%	5.9%	1.3%	82%

Impacts of the target-setting methodology changes:

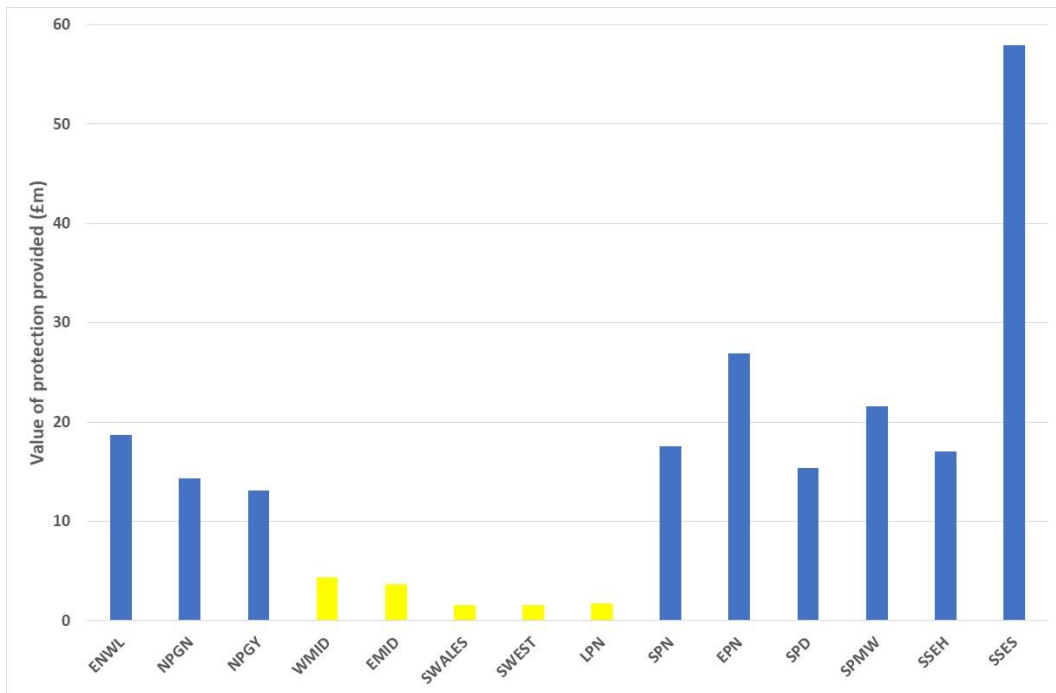
Each individual change softens the targets and collectively embed significant headroom in the revised targets to varying degrees for all DNOs. For example, headroom that is 41% of what the target would have been according to the original approach is now embedded in SPMW's targets (see Figure 5) whereas headroom of 1% has been embedded into SWEST's targets.

Figure 5: Headroom embedded in the unplanned CML targets



The embedded headroom provides the sector with substantial financial protection. We estimate the financial protection to be worth £215m over the RIIO-ED2 period.

Figure 6: Value of headroom embedded in the unplanned CML performance targets



* Companies shaded in yellow are the frontier companies, which would have set the benchmark for the sector according to the methodology set out at SSMD.

An alternative approach to setting targets:

We recognise that setting robust targets is not straightforward. We think setting rolling targets will moderate the issues highlighted above. At this stage, it is difficult to distinguish between genuine reducing opportunities to make improvements and performance that has been constrained by the combined effect of the cap on rewards and DNOs performing ahead of targets before the start of RIIO-ED1. Rolling targets, which are updated according to performance achieved during RIIO-ED2, are likely to be better at revealing genuine underlying performance. Also, setting rolling targets means there is less dependence on improvement factors to encourage improvement.

Performance improvements may accrue from expenditure not related to quality of service, such as the implementation of the recommendations of the Storm Arwen review and investment in network reliability. The impacts on performance would not be accounted for in the proposed target-setting methodology. Setting rolling targets will mitigate the risk of extended systematic outperformance and any performance gains to be derived from unrelated investment.

Core-Q49 Do you agree with our rationale for retaining our RIIO-ED1 position on QoS funding?

We agree with the rationale.

Core-Q52 Do you agree with our proposal not to have an end-of-period adjustment mechanism? If not, what criteria should we use to determine whether a DNO has used its allowance for WSC, without it creating uncertainty?

We do not agree with the proposal. Funding should be clawed back if it was not used for the purpose for which it was provided. We recommend that the DNOs be required to provide evidence supporting the decisions to incur expenditure. Funding should be clawed back if the information available to the DNOs when the decisions to incur expenditure were made does not support claims that the funding could have been used for the intended purpose.

Core-Q54 Do you agree with our proposed approach on NARM?

We do not agree with the entirety of the proposed approach to non-NARM assets, represent approximately 34% of the total asset replacement and refurbishment expenditure. It is not appropriate that outputs are not set and the DNOs will not be held accountable for delivery.

Core-Q55 Do you agree with our proposal to pass through SW 1-in-20 costs as a variant totex allowance rather than a fixed allowance in RIIO-ED2?

Core-Q56 Do you agree with our proposal to not set a cap for the amount that DNOs can adjust their allowance by, in the event they experience a SW 1-in-20 storm?

The proposals are reasonable. We recommend efficiency assessments are conducted and costs that are considered to be inefficient are disallowed.

Appendix 4: answers to the consultation questions – Finance Annex

Consultation question on allowed return on debt:

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

We agree it is appropriate to retain the approach to setting allowances for debt costs described at the (Sector Specific Methodology Decision (SSMD) unless more recent evidence suggests deviations from that approach are necessary. The proposed approach to setting allowances for debt costs is appropriate except in three areas – the halo effect, the small company/infrequent issuer premium and the cost to carry. We propose changes that would prevent allowances being higher than necessary. The proposed changes are summarised in Table 6 and further detail is provided below.

Table 6: Values of the 'halo' effect and the infrequent issuer premium

	Approach specified at SSMD	Draft Determinations	Centrica's proposal	Consumer benefit of proposed changes (£m)
'Halo effect'	<ul style="list-style-type: none">• Not assume a 'halo effect' for either embedded or new debt.	<ul style="list-style-type: none">• Not assume a 'halo effect' for either embedded or new debt.	<ul style="list-style-type: none">• Recognise the 'halo effect' and remove ex-ante allowances.• Introduce an uncertainty mechanism if necessary.• This represents a change to the approach specified at SSMD.	91
Small company or infrequent issuer premium	<ul style="list-style-type: none">• It was not suggested a premium was included in working assumptions.• The issue would be reviewed at Draft Determinations.	<ul style="list-style-type: none">• Infrequent issuer premium of 6bps allowed for LPN, NPGN and SWALES.	<ul style="list-style-type: none">• Remove the premium.• This does not represent a change to the approach specified at SSMD.	9
Cost to carry	<ul style="list-style-type: none">• Provide allowances for cost of carry	<ul style="list-style-type: none">• Provide allowances for cost to carry	<ul style="list-style-type: none">• Use the midpoint of the range to set allowances instead of 'aiming up'.• This does not represent a change to the approach specified at SSMD.	52

'Halo effect':

As discussed in the consultation, the decision at SSMD to not explicitly recognise the 'halo effect' was, in part, due to identifying a "much smaller positive 'halo effect'" when setting Final Determinations for the transmission and gas distribution companies in 2020²⁷. That outperformance was estimated to be 4bps on a weighted basis. The outperformance of the specified debt index is now estimated to be 7bps, 75% higher than that for the transmission and gas distribution companies.

²⁷ Finance Annex paragraph 2.14.
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We do not think it continues to be credible to not explicitly recognise the ‘halo effect’ when setting allowances for debt costs or to characterise it as small. Further, no evidence has been presented in the consultation to suggest the effect will not endure during the RIIO-ED2 price control. We estimate not explicitly recognising the ‘halo effect’ will result in revenues over RIIO-ED2 being about £91m higher than necessary (see Table 7).

We, therefore, recommend the ‘halo effect’ is explicitly recognised and a downward adjustment based on the observed recent market evidence is introduced ahead of the Final Determinations. To the extent there are concerns about whether the ‘halo effect’ will endure during RIIO-ED2, a mechanism can be designed to adjust allowances during the price control as an alternative to providing ex-ante allowances that may not be needed. Options for such a mechanism include, but are not limited to, indexing the ‘halo effect’ or a mechanism that can be triggered if the ‘halo effect’ is demonstrated to exist and exceeds a minimum threshold value (e.g. 4bps on a weighted average basis, which was previously considered small).

Infrequent issuer premium:

It is proposed that LPN (part of the UK Power Networks group), NPGN (part of the Northern PowerGrid group) and SWALES (part of the WPD group) will each be provided with an additional allowance of 6bps on the allowed cost of debt. The premium has been proposed to compensate those DNOs for the additional issuance costs they may face because they are expected to issue less than £150m per annum on average.

We do not think the need for a premium to be provided to the three relevant DNOs has been robustly justified. With the exception of ENWL, all DNOs have the option of managing their debt arrangements on a consolidated group basis and, so, may obviate the need for the relevant DNOs to be treated as infrequent issuers and for additional allowances. Retaining the infrequent issuer premium will result in revenues over RIIO-ED2 being about £9m higher than necessary (see Table 7).

We recommend Ofgem reconsiders whether including the infrequent issuer premium may provide companies with allowances that are not needed or may act as a disincentive to companies fully exploring all options to efficiently manage their debt costs.

Cost to carry:

It is proposed that the DNOs are provided with an uplift of 10bps to cover the cost to carry. The point estimate is the upper limit on what Ofgem considers to be a “plausible range” of 2-10bps²⁸. Ofgem ‘aimed up’ on the cost to carry by selecting the upper limit of the range as the point estimate.

No evidence has been presented in the consultation to justify the selection of any point estimate within the range or why ‘aiming up’ above the midpoint of the range is necessary. Setting the upper limit of the range as the point estimate for the cost to carry instead of the midpoint will result in revenues over RIIO-ED2 being about £52m higher than necessary (see Table 7).

We recommend the point estimate is set at the midpoint of the range unless an alternative point estimate can be robustly justified and can be demonstrated to be efficient.

²⁸ Finance Annex paragraph 2.28.
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Table 7: Revenue impacts of the 'halo' effect, the infrequent issuer premium and the cost to carry

DNO	Proposed base revenue (£m)	Revenue impact of the 'halo' effect (£m)	Revenue impact of the infrequent issuer premium (£m)	Revenue impact of the cost to carry not being set at the midpoint (£m)	Revised base revenue (£m)
ENWL	1,745	7	-	4	1,734
NPGN	1,322	5	3	3	1,311
NPGY	1,639	6	-	3	1,630
WMID	1,930	8	-	5	1,917
EMID	1,940	8	-	5	1,927
SWALES	971	4	3	2	962
SWEST	1,392	6	-	3	1,383
LPN	1,652	6	3	3	1,640
SPN	1,623	6	-	3	1,614
EPN	2,485	9	-	5	2,471
SPD	1,770	6	-	3	1,761
SPMW	1,777	7	-	4	1,766
SSEH	1,257	5	-	3	1,249
SSES	2,385	8	-	5	2,372
Sector	23,890	91	9	52	23,738

Step 1 - Consultation question on risk-free rate and equity indexation:

FQ3 In light of the upcoming change to the definition of RPI in 2030, should the RPI-CPIH inflation wedge be based on: a) a single year (as shown in the WACC allowance model when: cell D2 is "year 5 forecast" and cell B5 is "01/04/2022"); or b) should it be based on 20 years of inflation forecasts (as shown in the WACC allowance model when: cell D2 is "20 year geometric" and cell B5 is "01/04/2031")?

In light of the upcoming change to the definition of RPI in 2030, the RPI-CPIH inflation wedge should be based on a longer-run view of inflation (e.g. 20 years of inflation forecasts). There is a risk that key elements of the RIIO-ED2 price control such as change in the size of the regulatory asset value (RAV) and allowed returns could be mis-calibrated if too much emphasis is placed on shorter-term forecasts. This is a relevant consideration for RIIO-ED2 as the current elevated levels of inflation, and which are not expected to persist over the longer-term, will disproportionately influence the RPI-CPIH inflation wedge according to the existing methodology. This disproportionate influence will result in allowed revenues being higher than necessary but without a commensurate consumer benefit.

We note that, in the *PR24 Draft Methodology*, Ofwat proposes moving away from the Office for Budget Responsibility's (OBR's) long-term RPI-CPI 'static' wedge and in part because of the upcoming change to the definition of RPI in 2030. Ofwat states that its existing methodology that produce a value of 1.0% (which is equivalent to the value of 0.7% proposed in this consultation) is "likely to overstate the true average wedge over this period"²⁹.

²⁹ See pages 9-10 of: <https://www.ofwat.gov.uk/wp-content/uploads/2022/06/Appendix-11-Allowed-return-on-capital-appendix.pdf>.

Step 1 - Consultation questions on beta:

FQ7 Do you believe that DNOs have a higher or lower level of systematic risk than the GD&T companies during their respective RIIO-2 periods?

In our response to question FQ8 below, we explain why we think the DNOs have a lower level of systematic risk than the transmission and gas distribution companies during their respective RIIO-2 periods.

Nevertheless, even if the sectors are assessed to have similar levels of systematic risk, the beta estimates used to set the cost of capital for the transmission and gas distribution price controls should not be used for setting the cost of capital for RIIO-ED2. We previously highlighted that the beta estimates used to set the cost of capital for the transmission and gas distribution price controls did not take into account the impact of the several features in the RIIO-2 framework that have the effect of reducing systematic risk³⁰. These features include a shorter price control and the indexation of Real Price Effects. The impact of the reduced systematic risk was not captured in the mechanistic derivation of the beta estimates and neither was a downward adjustment made.

The features that have the effect of reducing systematic risk are also applicable to the RIIO-ED2 price control and their impacts should be captured. Simply adopting the beta estimates used to set the cost of capital for the transmission and gas distribution price controls will effectively overstate systematic risk and will result in the cost of capital being higher than its needs to be.

FQ8 What are your views on the relative risk comparison shown in Table 10?

We agree with the assessment relating to the areas in which systematic risk is lower than or is similar to that for the other network sectors. However, we do not agree with the assessment that the DNOs are exposed to higher systematic risk in the three areas identified. We think all three areas provide upside opportunities for the DNOs instead of exposing the DNOs to higher systematic risk. We explain below.

RoRE ranges appear larger for DNOs:

We do not believe the DNOs are exposed to greater downside risk even though the return on regulatory equity (RoRE) ranges appear presentationally larger for DNOs. As acknowledged in the consultation, there is a difference between possible outcomes and probable outcomes³¹. We agree. It would be incorrect to assume that the largest downside shown in any RoRE chart has precisely the same probability as the largest upside.

We have identified aspects of the proposals that provide the DNOs with significant protection against downside risk, such as the proposed calibrations of the Complaints Metric and the Interruptions Incentive scheme. We have also identified areas in which the proposed allowed return on capital is unnecessarily generous. These areas include a downward adjustment not being made for the allowed cost of debt in recognition of the 'halo effect' and allowances for the cost to carry being set at the upper limit of the range. Also, allowances for equity issuance costs have been described as generous by Ofgem.

³⁰ In our evidence to the Competition and Markets Authority for the RIIO-2 Energy Licence Modification Appeals.

³¹ Finance Annex paragraph 3.109.

Taken together, these factors represent significant protection against downside risk and increased upside opportunity. The probability of outperformance significantly outweighs that of underperformance.

Totex incentive rates are higher than in the transmission sectors:

We accept that the higher totex incentive rates require the DNOs to bear a greater portion of overspend relative to the transmission companies. However, we do not believe the higher totex incentive rates automatically translate into higher systematic risk. The DNOs hold a natural informational advantage over Ofgem, which leads to systematic bias in favour of the DNOs. Ofgem relies on the information provided by the DNOs when setting the price controls. For example, Ofgem makes use of, among other things, the DNOs' views of forecast costs and volumes to set the price control. The allowed costs and volumes will be influenced by the information provided by the DNOs. Without a genuinely and wholly independent view (which the DNOs cannot provide), a systematic bias exists. All other things being equal, the existence of information asymmetry provides some protection against overspending.

The scale of investment relative to RAV could be larger for DNOs:

It is unclear why the scale of investment relative to RAV is thought to represent higher risk to the DNOs. The analysis presented in the consultation suggests that either financeability will not be compromised by the scale of investment and/or appropriate mitigations can be put in place.

Step 2 - implied cost of equity consultation questions:

FQ10 Do you agree with our interpretation of the cross-check evidence?

We agree with the interpretation of the cross-check evidence.

FQ11 Do you agree with our updated MAR and OFTO cross-check techniques, in terms of drawing better inferences for RIIO-ED2?

We agree with the updated (Market to Asset Ratios) MAR and Offshore Transmission Network Operator (OFTO) cross-check techniques.

FQ12 Do you agree with the cross-checks we have used and are there other cross-checks we should consider?

We agree with the cross-checks used.

FQ13 Do you consider we should put greater weight on cross-checks or reconsider our CAPM parameters in light of the adjusted cross-check results?

We believe greater weight should be placed on the cross-checks and the Capital Asset Pricing Model (CAPM) cost of equity should be adjusted in light of the evidence derived from the cross-checks.

The cross-checks have been used primarily to assess whether the CAPM cost of equity is too low. However, we think the cross-checks can and should be used to assess whether the CAPM cost of equity is too high. It is clear Ofgem shares our view that the cross-checks can be used to assess whether the CAPM cost of equity is too high – Ofgem states the cross-checks support values in the lower half of the CAPM range³². In other words, Ofgem suggests the CAPM cost of equity is too high.

It is proposed that the CAPM cost of equity is not adjusted downward even though the cross-checks support values in the lower half of the CAPM range, in order to maintain consistency with the equivalent decision in the RIIO-GD&T2 Final Determinations. It was also proposed because no cross-check is considered to be perfect. We strongly disagree. The proposal to not place any weight on the evidence provided by the cross-checks is not justified.

Firstly, consistency should not be maintained simply for the sake of doing so. Decisions should be based on evidence and robustly justified. In this instance, we consider that not making a downward adjustment in order to maintain consistency with a previous decision does not align with the evidence presented in the consultation. Secondly, in any event, we continue to believe the decision to not make a downward adjustment in the RIIO-GD&T2 Final Determinations was not supported by the evidence derived from the cross-checks and was not in consumers' interests³³. Thirdly, even though no cross-check is perfect, the contextual information provided by the cross-check should not be ignored. Ofgem, too, shares this opinion³⁴. However, Ofgem implicitly has ignored the evidence provided by the cross-checks by not adjusting the CAPM cost of equity downwards.

We acknowledge it may not always be possible to use the evidence derived from the cross-checks in a mechanistic way to adjust the CAPM cost of equity. However, that does not prevent weight being placed on the evidence from the cross-checks and does not prevent regulatory judgement being exercised to make reasonable adjustments to the CAPM cost of equity.

We are concerned that the decision to not make a downward adjustment in the RIIO-GD&T2 Final Determinations, and which we consider was not in consumers' interests, could be repeated for RIIO-ED2. We consider a similar decision but for the RIIO-ED2 price control will also not be in consumers' interests. By way of illustration, if we assume the allowed cost of equity is set at 4.0%³⁵ instead of at 4.75% as proposed, consumers will not need to fund additional revenues worth £457m (see Table 8).

³² Finance Annex page 50.

³³ We estimate the decision to not make a downward adjustment of 15bps resulted in consumers being required to fund revenues that are about £191m higher than necessary.

³⁴ For example, Ofgem states that MAR evidence should not be discarded or ignored even though there is uncertainty in the link between equity returns and MARs.

³⁵ The average of the cost of equity from all the cross-checks except the unadjusted parameters.

Table 8: Revenue impacts if the allowed cost of equity is set at 4.0%

DNO	Draft Determinations		Cost of Equity of 4.0%			
	Base revenue (£m)	RoRE (%)	Base revenue (£m)	Revenue variance (%)	RoRE (%)	RoRE variance (%)
ENWL	1,745	4.37%	1,713	-1.9%	3.61%	-17.4%
NPGN	1,322	4.24%	1,299	-1.8%	3.48%	-17.9%
NPGY	1,639	4.74%	1,606	-2.0%	3.98%	-16.0%
WMID	1,930	4.75%	1,889	-2.1%	4.00%	-15.8%
EMID	1,940	4.75%	1,898	-2.2%	4.00%	-15.8%
SWALES	971	4.75%	950	-2.2%	3.99%	-16.0%
SWEST	1,392	4.88%	1,361	-2.3%	4.12%	-15.6%
LPN	1,652	4.78%	1,624	-1.7%	4.02%	-15.9%
SPN	1,623	4.77%	1,594	-1.8%	4.02%	-15.7%
EPN	2,485	4.78%	2,441	-1.8%	4.03%	-15.7%
SPD	1,770	4.69%	1,739	-1.7%	3.94%	-16.0%
SPMW	1,777	4.67%	1,743	-1.9%	3.92%	-16.1%
SSEH	1,257	4.73%	1,234	-1.8%	3.97%	-16.1%
SSES	2,385	4.73%	2,342	-1.8%	3.97%	-16.1%
Sector	23,890	4.69%	23,433	-1.9%	3.94%	-16.1%

* NPV-neutral RoRE values are based on the notional DNO, sectoral figures are revenue-weighted.

Step 3 - allowed return on equity consultation questions:

FQ14 Do you agree that we should not adjust for expected outperformance when setting baseline allowed returns on equity?

We do not agree with the proposal to not adjust for expected outperformance.

We acknowledge that the proposal to remove the outperformance wedge reflects an element of the Competition and Markets Authority's (CMA's) decision in the RIIO-2 appeals for the transmission and gas distribution sectors. The CMA stated:

We consider that GEMA has not shown why a downward adjustment to the allowed cost of equity (through the application of an outperformance wedge) is an appropriate and targeted way of addressing relevant concerns associated with operational (ie ODI and/or totex) outperformance³⁶. [emphasis added]

The CMA considered:

- the wedge to be a poorly targeted way of addressing risks to consumers associated with totex outperformance;
- the wedge results in differences in the scale of the effective totex challenges faced by different licensees that appear to be arbitrary and discriminatory and that have not been sufficiently justified by GEMA;
- that GEMA has not identified sufficiently why the set of tools it used for RIIO-2 should be regarded as providing insufficient protection for customers in relation to baseline totex allowances; and

³⁶ "Final determination Volume 2B: Joined Grounds B, C and D"; paragraph 6.153.
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- the design and calibration of the output delivery incentive (ODI) arrangements gives GEMA a broad range of potential options through which it can manage the risks to consumers associated with unmerited ODI outperformance in a more targeted way.

One of the CMA's primary concerns was that the wedge was poorly designed when it decided the wedge should be removed.

The CMA did not state that expected outperformance, or what we phrase as 'embedded' outperformance, should not be addressed. In fact, the CMA considered "...the overall extent of operational outperformance in RIIO-1 to have provided strong support for GEMA treating the scope for operational outperformance as an important risk area for RIIO-2..."³⁷. The principle of addressing expected outperformance and the form of the wedge that was proposed for the other RIIO-2 price controls should not be conflated as they are not the same thing. The proposal to not adjust for expected outperformance is not consistent with the CMA's decision. An improved form of the wedge, or any another type of mechanism, that addresses the concerns the CMA previously highlighted could be implemented.

The absence of a mechanism would be less problematic if the relevant aspects of the price control are appropriately calibrated to reduce the risk of 'embedded outperformance', thereby addressing the problem 'at source'. However, we do not believe all relevant aspects have been appropriately calibrated. For example:

- it is proposed that 'use it or lose it' funding that will be provided to improve network reliability for worst served customers will not be clawed back if it identified that the funding has been used for a purpose other than why it was originally provided.
- the greater proportion of expenditure allowances that will be provided via uncertainty mechanisms increases the risks associated with systematic bias associated with information asymmetry.

FQ15 Do you believe there is new evidence which would support an adjustment downwards (eg expected outperformance) or upwards (eg aiming up) that we have not yet considered?

There is evidence in the consultation that supports an adjustment downwards. A downward adjustment is also necessary because of the interaction with the Returns Adjustment Mechanism (RAM). The proposed allowed return on equity will allow DNOs to retain more returns (in monetary terms) before the primary or secondary thresholds are triggered. Conversely, the proposed allowed return on equity provides the DNOs with more downside protection since more underperformance (in monetary terms) will be shared with consumers than intended.

The evidence in the consultation that supports an adjustment downwards is summarised in the table below.

³⁷ "Final determination Volume 2B: Joined Grounds B, C and D"; paragraph 6.91.
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Table 9: Evidence supporting a downward adjustment on the proposed return on equity

Area	Detail
'Aiming up' up when setting the proposed cost of debt	<ul style="list-style-type: none"> • a downward adjustment has not been made to recognise the existence of the 'halo effect'. • the upper limit of a range has been selected for the cost to carry.
'Aiming up' when setting the proposed cost of equity	<ul style="list-style-type: none"> • allowances for equity issuance costs have been described as "even generous" by Ofgem. In other words, the allowances are higher than they need to be. • the beta estimates have not been adjusted for the reduced systematic risk to which the DNOs are exposed but would not have been reflected in the estimation methodology, such as the greater use of volume drivers and the indexation of Real Price Effects.
Effectively 'aiming up' when setting the proposed cost of equity	<ul style="list-style-type: none"> • a downward adjustment has not been made to reflect the evidence derived from the Step 2 cross-checks.
'Aiming up' when setting the proposed return of equity	<ul style="list-style-type: none"> • a mechanism that addresses expected outperformance has not been included.
Reducing downside risk by embedding significant protection when calibrating some incentives.	<ul style="list-style-type: none"> • the proposed calibration of the Complaints Metric does not embed performance levels achieved, provides significant protection against penalties and unnecessarily dulls the financial impact of any penalty. • the proposed calibration of the Interruptions Incentive Scheme provides significant protection even though it has not been robustly demonstrated that the target-setting methodology requires revision.

Inflation and WACC consultation questions:

FQ16 Do you think we should adjust our approach to allowed returns (noting our approach to expected inflation for WACC and outturn inflation for RAV as described above) so that outturn inflation does not permit the notional company to generate real equity returns that are materially higher or lower than our cost of equity allowance? What would be the consequences to consumers and DNOs of doing so?

We think careful consideration should be given as to whether the approach should be adjusted. We note this is not just a matter for the RIIO-2 price controls; inflation being materially higher than expected is also relevant to the RIIO-ED1 price control.

Ofgem previously indicated its willingness to consider measures to ease notional company financeability constraints following a period of very low inflation if they occur. Similar measures to protect consumers in the event of high inflation have not yet been considered. Inflation has regularly exceeded (or fallen below) the long-run inflation assumption embedded in the cost of capital calculations. Moderate deviations from the long-run inflation assumption, whether upward or downward, should not warrant regulatory intervention. However, there appears to be a stronger case for intervention if inflation is expected to materially exceed the long-run assumption, especially given the protection the companies may benefit from if periods of very low inflation occur.

'Leveraging' effect:

Inflation being higher than the long-run assumption has a 'leveraging' effect because returns are naturally higher because the RAV is inflation-linked and the value of equity also increases and generates additional returns. The additional returns that are generated as a result of the increase

in the value of equity are effectively a capital gain and are not due to company performance. The mechanics of the ‘leveraging’ effect is shown below in Table 10.

Table 10: Movement of financial parameters as a result of higher inflation

Parameter	Impact of higher inflation	
Nominal RAV (£m)	The RAV is indexed to inflation. Higher outturn inflation will result in increased growth of the nominal RAV base.	↑
Gearing (%)	25% of the notional licensee’s debt is assumed to be CPIH linked and the remainder is assumed to be nominal debt. As a result, although net debt increases with higher inflation, the increase is at a slower rate than RAV growth. This means that gearing declines overall.	↓
Equity RAV (£m)	The equity portion of RAV increases due to the resulting growth in the nominal RAV.	↑
Allowed returns (£m)	Allowed returns (i.e. profits) are set in real (CPIH) terms but initially calculated in nominal terms. Allowed returns will be higher as a result of inflation being higher anticipated.	↑
RoRE (£m)	RoRE increases in absolute terms as regulatory equity rises when (nominal) RAV is indexed to high outturn inflation. This is a capital gain to investors, over and above any impact on the actual rate of return.	↑

Scenario analysis:

We conducted a scenario analysis³⁸ so as to quantify the potential impact on consumers of inflation being materially higher than the long-run inflation assumption. We compared the differences in base revenues (as a proxy for the impact on customer bills) and RoRE (as a proxy for shareholder returns) across RIIO-ED2 for each of the 14 DNOs. The counterfactual scenarios we modelled are (see Table 11):

- Scenario 1 (‘High inflation’): inflation is assumed to be significantly higher than the long-run 2% assumption proposed by Ofgem based on the OBR’s March 2022 forecast during the first two years of RIIO-ED2. Inflation is assumed to approximate to the long-run assumption thereafter. Returns and revenues are updated mechanistically as per the current methodology.
- Scenario 2 (‘Impact spread over RIIO-ED2’): the inflation out-turn as above in scenario 1 is assumed. However, expected short-run inflationary impacts are spread over the RIIO-ED2 period in order to limit the impact of the inflationary impacts on revenues during the first two years of RIIO-ED2.

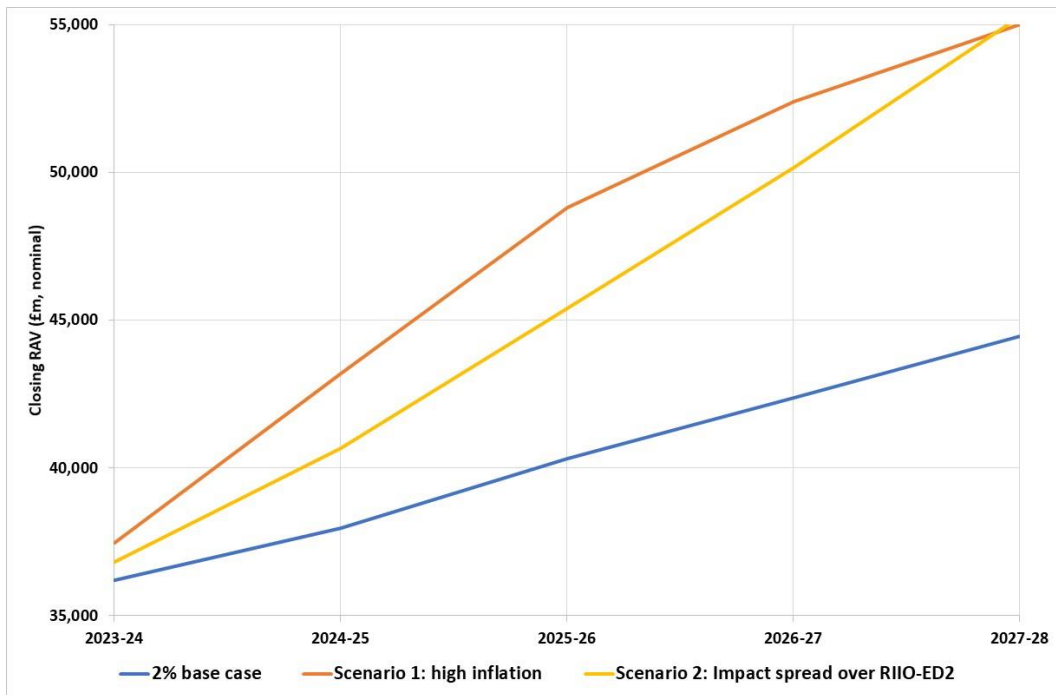
Table 11: Inflation (CPIH) assumptions

Inflation scenario	2023-24	2024-25	2025-26	2026-27	2027-28
Status quo (2% long-run assumption)	1.5%	1.9%	2.0%	2.0%	2.0%
Scenario 1: High inflation	13.0%	10.0%	5.0%	2.0%	2.0%
Scenario 2: Impact spread over RIIO-ED2	7.2%	7.2%	7.2%	7.2%	7.2%

The impact of inflation on RAV growth is shown in Figure 7. The sectoral RAV would grow by about 23% if out-turn inflation approximates to the long-run assumption, but by about 47% in both counterfactual scenarios. We highlight that the impact of higher inflation on RAV growth is not just a matter for RIIO-ED2; the elevated RAV growth in RIIO-ED2 will also feed into revenues in subsequent price controls.

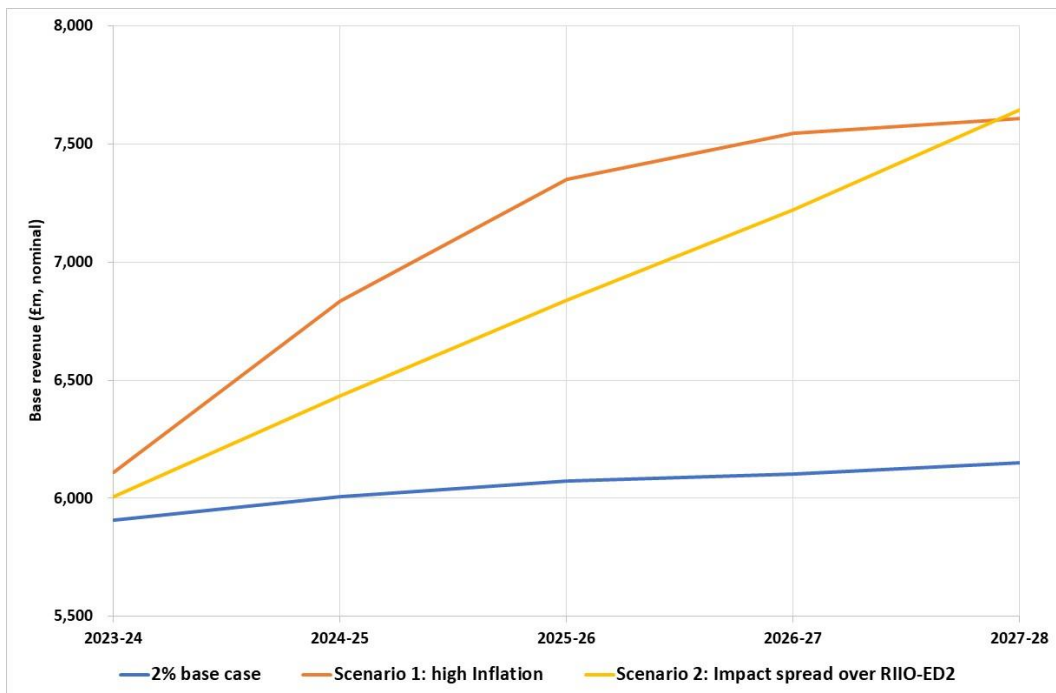
³⁸ The analysis was based on the notional DNOs.

Figure 7: Sectoral closing RAVs under each inflation scenario



As shown in Figure 8, the impact of inflation on revenues follows a similar trajectory. Sectoral revenues would increase by 4% over RIIO-ED2 if out-turn inflation approximates to the long-run assumption. However, revenues at the end of RIIO-ED2 in both counterfactual scenarios would be about 29% higher than revenues at the start of the price control in the base case.

Figure 8: Sectoral revenues under each inflation scenario



The average DNO would receive additional revenue worth £372m (17% higher) over RIIO-ED2 under the high inflation scenario. In the scenario in which the inflationary impact is 'smoothed' over RIIO-ED2, the average DNO would receive additional revenue worth £279m (12% higher than revenues in the base scenario). The data for the DNOs are shown in Table 12.

Table 12: Revenues

	Status Quo	Scenario 1: High inflation		Scenario 2: Impact spread over RIIO-ED2	
DNO	Base revenue (£m)	Base revenue (£m)	Variance (£m)	Base revenue (£m)	Variance (£m)
ENWL	2,209	2,588	379	2,493	284
NPGN	1,674	1,963	289	1,891	217
NPGY	2,075	2,434	359	2,346	271
WMID	2,444	2,865	421	2,759	315
EMID	2,456	2,880	424	2,775	319
SWALES	1,229	1,443	214	1,390	161
SWEST	1,763	2,069	306	1,993	230
LPN	2,091	2,450	359	2,360	269
SPN	2,055	2,409	354	2,320	265
EPN	3,147	3,690	543	3,555	408
SPD	2,238	2,616	378	2,520	282
SPMW	2,250	2,638	388	2,541	291
SSEH	1,590	1,861	271	1,792	202
SSES	3,021	3,545	524	3,415	394
Average	2,160	2,532	372	2,439	279

The analysis in Table 13 shows that RoRE (in monetary terms) and total returns (%) would be higher in both counterfactual scenarios. In the high inflation scenario, RoRE for the average DNO would be £309m or about 18% higher than returns in the base scenario over the RIIO-ED2 period. However, when the additional return accruing from the higher equity RAV is taken into account, total returns to the average DNO are about 23%. The total returns include the capital gain that accrues to shareholders because of higher inflation³⁹.

In the scenario in which the impacts of higher inflation are spread across RIIO-ED2, RoRE for the average DNO would be £298m or about 13% higher than returns in the base scenario. However, when the additional return accruing from the higher equity RAV is taken into account, total returns to the average DNO are about 19% higher.

³⁹ RoRE in percentage terms is about the same the counterfactual scenarios as in the base case because of the larger RAVs. For simplicity, the base case RoRE in percentage terms was used in both counterfactual scenarios.

Table 13: RoRE and total returns

DNO	Status Quo		Scenario 1: High inflation				Scenario 2: Impact spread over RIIO-ED2			
	RoRE (£m)	RoRE (%)	RoRE (£m)	Reg equity * RoRE	RoRE Difference (£m)	Total Returns (%)	RoRE (£m)	Reg equity * RoRE	RoRE Difference (£m)	Total Returns (%)
	A	B	C1	D1 (=B*C1)	E1 (=C1-A)	F1 (=D1+E1)/A	C2	D2 (=B*C2)	E2 (=C2-A)	F2 (=D2+E2)/A
ENWL	245	4.37%	288	13	44	23%	278	12	33	19%
NPGN	170	4.24%	200	9	30	23%	193	8	23	18%
NPGY	263	4.74%	309	15	46	23%	298	14	35	19%
WMID	337	4.75%	396	19	59	23%	381	18	45	19%
EMID	343	4.75%	403	19	60	23%	389	18	46	18%
SWALES	171	4.75%	202	10	30	23%	195	9	23	19%
SWEST	266	4.88%	313	15	47	23%	302	15	36	19%
LPN	228	4.78%	268	13	40	23%	258	12	30	19%
SPN	238	4.77%	280	13	42	23%	270	13	32	19%
EPN	365	4.78%	429	20	64	23%	413	20	49	19%
SPD	248	4.69%	292	14	44	23%	282	13	34	19%
SPMW	276	4.67%	326	15	49	23%	314	15	37	19%
SSEH	183	4.73%	216	10	33	24%	208	10	26	19%
SSSES	347	4.73%	409	19	62	23%	394	19	47	19%
Average	263	4.69%	309	15	47	23%	298	14	35	19%

The analysis shows that allowed revenues (a proxy for customer bills) and RoRE (a proxy for profit or returns to shareholders) will be significantly higher in a scenario in which out-turn inflation is materially above the long-run assumption. The analysis also shows that spreading the impact of higher inflation in the earlier years over price control does not offer much protection to consumers during RIIO-ED2. We recommend Ofgem considers this matter in greater detail, to assess whether requiring the additional revenues to be funded is in consumers' interests. Ofgem should carefully consider whether intervening to protect consumers' interests is necessary, whilst also being mindful of any unintended consequences.

FQ17 If you believe we should make such an adjustment, what is the best method for making it?

At this stage, it is not clear what would be the best method for making an adjustment if it is needed. However, Ofgem could consider the appropriateness of including inflation within the scope of the RAM.

Consultation question on Return Adjustment Mechanisms:

FQ27 Do you agree with our proposals for the RAM thresholds and adjustment rates?

The adjustment rates are reasonable but the proposed thresholds appear to make the RAM less effective than intended as a safeguard against returns being significantly higher than anticipated.

We 'sense-checked' the potential effectiveness of the RAM by estimating the degree of totex under-spend that the DNOs would need to achieve in order for both thresholds to constrain returns in two illustrative scenarios:

- DNOs achieving 50% of the maximum aggregate upside rewards available from the output delivery incentives (ODIs); and
- DNOs achieving the maximum aggregate upside rewards available from the ODIs.

These scenarios were selected because we consider these degrees of sectoral outperformance to be suggestive of systematic outperformance and that the price control may have mis-calibrated.

As shown in Table 14, the companies would need to under-spend by 12% and 18% respectively for the primary and secondary thresholds to be triggered in a scenario in which they achieve 50% of the maximum ODI rewards. The degrees of under-spend reduce to 6% for the primary threshold to be triggered and 12% for the secondary threshold to be triggered if the DNOs achieve the maximum ODI rewards. The scenarios are illustrative and, in practice, there will be myriad combinations of ODI performance and totex outcomes; it is the overall level of returns that are relevant. Nevertheless, we do not think that a scenario in which the sector earns the maximum ODI rewards and then further needs to under-spend expenditure allowances by 12% would be a desirable outcome of a settlement that has been presented as tough and fair and provides strong challenge.

Table 14: Degrees of totex under-spend

DNO	Scenario 1: ODI performance of 50% of the maximum upside			Scenario 2: maximum ODI upside performance		
	ODI RoRE	Under-spend required to hit primary threshold	Under-spend required to hit secondary threshold	ODI RoRE	Under-spend required to hit primary threshold	Under-spend required to hit secondary threshold
ENWL	1.08%*	10.3%	15.7%	2.15%*	4.6%	9.9%
NPGN	0.98%	11.6%	17.4%	1.95%	6.0%	11.8%
NPGY	0.98%	11.7%	17.5%	1.95%	6.1%	11.9%
WMID	0.98%	15.2%	22.7%	1.95%	7.9%	15.4%
EMID	0.98%	14.4%	21.6%	1.95%	7.5%	14.6%
SWALES	0.98%	12.4%	18.6%	1.95%	6.4%	12.6%
SWEST	0.98%	13.4%	19.9%	1.95%	6.9%	13.5%
LPN	1.08%**	12.1%	18.4%	2.15%**	5.3%	11.6%
SPN	0.98%	12.0%	17.8%	1.95%	6.2%	12.1%
EPN	0.98%	12.4%	18.5%	1.95%	6.4%	12.6%
SPD	0.98%	11.9%	17.7%	1.95%	6.1%	12.0%
SPMW	0.98%	12.8%	19.1%	1.95%	6.6%	13.0%
SSEH	0.98%	9.5%	14.2%	1.95%	4.9%	9.6%
SSSES	0.98%	10.9%	16.2%	1.95%	5.6%	11.0%
Total	0.98%***	12.2%	18.3%	1.95%***	6.3%	12.4%

* ENWL has an additional ODI upside opportunity of +/-0.2% RoRE for the 'Dig fix and go' bespoke ODI.

** LPN has an additional ODI upside opportunity of +/-0.2% RoRE for 'collaborative street works' bespoke ODI.

*** the impact of bespoke ODIs is excluded is the overall sector figures.

We think the mechanism, as currently designed, will offer limited protection against systematic outperformance. We accept that the price control should be calibrated to offer opportunities for outperformance but it should also be fair to both consumers and investors. We do not think the

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proposed thresholds represent an appropriate balance between consumers and investors with respect to systematic outperformance, especially given the protections that could be offered to companies if they experience financeability constraints⁴⁰.

Questions on consolidated reporting and calculation of allowed revenue:

FQ34 What are your views on the proposed consolidation of the revenue RRP and PCFM, or applying a fully dynamic concept of allowed revenue?

The proposal is reasonable.

Questions on licensee self-publication of allowed revenue

FQ35 What are your views on allowing licensees to self-publish the PCFM with their charging statements, rather than relying on an Ofgem publication or direction to determine allowed revenue?

As with the proposed approach to forecasting, (see question FQ38), we are not objecting to the proposal is contingent upon the 15-month notice period for changes to network charges remaining unchanged. This policy will need to be reviewed if the notice period is shortened.

Questions on best vs reasonable endeavours in charge setting

FQ36 What are your views on having a best endeavours obligation for charge setting: "The licensee must, when setting Network Charges, use its best endeavours to ensure that Recovered Revenue equals Allowed Revenue"?

We support this proposal.

Question on forecasting

FQ38 What are your views on our proposed approach to using forecasts within RIIO-ED2?

This proposal, along with other proposed changes such as allowing DNOs to self-publish the Price Control Financial Models, will increase the unpredictability of allowed revenues and, by extension, network charges. The increase in the unpredictability will be due to several factors including the lack of transparency of the underlying assumptions and the variability in the approaches to forecasting.

The risk to suppliers and consumers arising out of the increase in unpredictability is partially mitigated by the 15-month notice period for changes to network charges. As such, we do not object to the proposal contingent upon the 15-month notice period remaining unchanged. This policy will need to be reviewed if the notice period is shortened.

⁴⁰ For example, see: <https://www.ofgem.gov.uk/sites/default/files/docs/2008/12/position-paper---responding-to-deteriorating-financial-health-final.pdf#page%3D1>.

Questions on forecasting penalty mechanism:

FQ39 What are your views on the proposed charging penalty mechanism?

We support this proposal.

FQ40 What are your views on the proposed revenue forecasting penalty mechanism?

We support this proposal.

Consultation question on incentive lags:

FQ41 What are your views on removing lags from incentives?

As with the proposed approach to forecasting, (see question FQ38), we do not object to the proposal contingent upon the 15-month notice period for changes to network charges remaining unchanged. This policy will need to be reviewed if the notice period is shortened.

Consultation question on baselines for ODI incentive rates, caps, and collars:

FQ42 What is your view on using RoRE as a general baseline for describing ODI caps, rather than base revenue?

The approach is reasonable.

FQ43 What is your view on fixing the potential £m 20/21 value of incentives using one number for all years, based on a forecast of RIIO-ED2 at Final Determinations (an approach similar to RIIO-ED1)?

The approach is reasonable.

FQ44 What is your view on the method of calibrating incentive caps in RoRE terms, or the overall proposed incentive caps?

The approach is reasonable.

Consultation question on revenue profiling:

FQ46 Should Ofgem allow proposals to re-allocate or re-profile revenue throughout the RIIO-ED2 period and what profiles could be considered in the customers' interest?

Proposals to 'smooth' revenues throughout the RIIO-ED2 period should be considered. As shown in Table 15, the year-on-year changes in base revenue are volatile. It is preferable that the volatility is reduced.

Table 15: Year-on-year changes in base revenues

DNO	2023-24	2024-25	2025-26	2026-27	2027-28
ENWL	11%	-4%	-2%	-2%	-1%
NPGN	0%	-2%	-1%	-1%	0%
NPGY	-7%	-3%	-1%	-3%	-2%
WMID	-9%	-3%	-1%	-2%	-1%
EMID	-4%	-2%	0%	-1%	-1%
SWALES	-4%	-2%	-1%	-1%	-1%
SWEST	-15%	-1%	-6%	-4%	-3%
LPN	-6%	-2%	-5%	-3%	-2%
SPN	-11%	-2%	-1%	-2%	-1%
EPN	13%	-3%	-19%	-1%	-2%
SPD	18%	-2%	-1%	-1%	-3%
SPMW	-11%	0%	-3%	-6%	-4%
SSEH	-4%	1%	1%	-3%	-3%

* Changes in 2023-24 are relative to revenues in the final year of RIIO-ED1.