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By email to FutureNetworkRegulation@ofgem.gov.uk

Dear Akshay and Rebecca,

Future Systems and Network Regulation open letter

Thank you for the opportunity to respond to the Future Systems and Networks Regulation Open Letter that sets out Ofgem's initial thinking regarding the approach to the next network price control period. This is an important point in time for the energy sector as we continue our transition towards a decarbonised network. It is important that the regulatory structures are kept under review to maintain their ability to deliver the best customer outcomes against this backdrop of change, uncertainty and the increasing need for resilience and integration. In summary, SGN's view is that;

- **The current regulatory building blocks provide a suitable basis from which to evolve and improve.**
- **A fundamental change in the regulatory approach for the next price control is neither feasible nor desirable due to the risk of unintended consequences and loss of confidence in regulatory structures.**
- **There may be a case for regulatory change in future regulatory periods, however, this should be based on a clear problem statement, and clear objectives, and should also include significant industry engagement.**
- **There are significant improvements that can be made in the existing regulatory process to reduce regulatory burden and increase transparency and we would welcome engagement with Ofgem on these opportunities.**

SGN is a gas transporter that operates in two licence areas, Scotland and Southern, across which we serve approximately 6 million customers, with our distribution networks covering the most densely populated regions of central London and the most sparsely populated regions of Scotland. Our customers are highly diverse in terms of their background, their expectations, and their needs. We keep our customers at the forefront of our thinking when considering any regulatory process, as the regulatory process must create outcomes that are supported by our customers and deliver to their needs and expectations.

From the open letter, we note that the customer and delivering a customer-focused outcome was not as prevalent as we had anticipated. A positive outcome from RIIO-GD2 was the role of the customer engagement group in supporting a business plan that was more comprehensive in its consideration of customer expectations and priorities. We believe this should continue to be an important factor in the future regulatory process.

The principal priority for SGN's customers has been, and we are confident will remain, to maintain safety and it is important that the regulatory structure allows sufficient investment to maintain and improve safety across the network. After safety, customers will place varying weights on the different aspects of the energy trilemma. Following the economic events of the last year, we anticipate that security of supply, resilience, and affordability will be key secondary considerations. The focus on this edge of the energy trilemma contrasts with the focus on methane emissions that was prevalent following the Glasgow COP26 and demonstrates that the regulatory framework needs to remain responsive to changes in our customer priorities and to provide points of recalibration as those priorities change.

As well as maintaining the safety and resilience of the energy system, the regulatory structure needs to enable and facilitate the move to net zero and the decarbonisation of the energy system in a least-cost manner. This is a challenge as there is no current certainty surrounding the least-cost pathway and the extent to which domestic and commercial heat will be decarbonised through electricity, hydrogen, or an alternative energy source. It is however clear that this will take time, and whilst that transition takes place, we have an obligation to continue to provide heat to our customers safely and reliably.

At the same time, the regulatory framework has to enable 'investment in' and attract 'investment to' the assets needed to transition to a decarbonised system. This investment will take place in a state of imperfect information, which applies equally to the investors and to the regulator. It is our view that the open letter is inaccurate in its characterisation of a one-sided information asymmetry experienced by the regulator in isolation and is counter to the direct experience realised in RIIO-GD2.

We recognise the challenges that the regulator sets out in the open letter on future systems and network regulation, and the importance of securing a regulatory structure that is appropriate for the challenges that will be experienced. The open letter, however, casts the net of potential regulatory change very wide and we do not consider that the case for fundamental reform of the regulatory structure has been sufficiently demonstrated. We are concerned that regulatory reform could become a distraction from improving the delivery of a least-cost decarbonisation pathway.

We consider there to be a significant risk associated with fundamental regulatory change at this point in time given the complexity of such change, the lack of clarity regarding the intended outcome of that regulatory change, the risk of unintended consequences, and the risk of delay with the resulting impact on investor confidence. There is a significant 'opportunity-cost' of directing time and resources to alter the fundamentals of regulatory structure for what we consider to be of limited benefit, rather than focusing on the material details that need careful consideration and assessment.

The importance of timing and what is practical is brought into sharp consideration when assessing the timelines involved. The next regulatory period will start in April 2026; to achieve this date, final business plans are expected to be submitted in December 2024 and we anticipate a draft business plan submission in mid-2024. Accordingly, networks have already started their planning and stakeholder engagement strategies.

Considering this timeline, SGN's recommendation is that sharp focus should be placed on specific areas of the regulatory structure where change can deliver a better customer outcome through a more effective regulatory process. SGN is of the view that the regulatory tools necessary to accommodate the challenges of a changing energy system landscape largely exist within the current regulatory toolkit and are a matter of adaptation and improvement rather than wholesale change.

SGN proposes that a focus on improving the effectiveness of the regulatory structure to deliver a better customer outcome and improve the efficiency of the regulatory process is the most appropriate way forward. Set out below are some key areas where improvements could be made to facilitate consistency, support comparability and reduce the regulatory burden:

1. **Consistency in business plan structure.** In RIIO-GD2 networks interpreted broad guidance to the best of their ability, resulting in plans being submitted on an inconsistent and incomparable basis. We would support alignment and consistency in submission format and data representation to improve transparency and comparability.
2. **Consistency in approach to uncertainty.** In RIIO-GD2 there was inconsistency between network plans on how uncertainty should be represented in the baseline plan and where risk should be allocated between networks and customers. We would support a consistent point of reference against which plans are assessed to avoid the risk of distortions.
3. **Consistency in the allocation of project risk.** In RIIO-GD2 there was no real discussion on the way risk should be considered for projects according to their stage of development. This has been introduced in the reopener guidance, and we would encourage the approach to be formalised to support transparency and consistency.
4. **Consistency in the role of customer engagement.** Our RIIO-GD2 business plan was significantly improved through the work of the customer engagement group, however, there was a disconnect between the outcomes of customer-led engagement and how these are reflected in the benchmarking model (where they are reflected as inefficiencies). We would support consistency in understanding how customer and stakeholder engagement can truly impact the outcome.

The above is not an exhaustive list, but each reflects an important area in which focusing attention at the outset of the price control can deliver significant benefits from a reduced regulatory burden in the later stages of the price control. We believe that this should be the focus at this point in the regulatory cycle and that the building blocks should remain and evolve where necessary. Many of the alternative options set out in the open letter risk either delaying the regulatory burden to the end of a project or price control or transferring it to another party, we believe this approach only risks moving the problem rather than addressing the root cause.

SGN welcomes the open letter as an important staging post from which to develop our thinking and approach. We would welcome the opportunity to engage further with Ofgem on these important topics.

Best regards



David Handley,
Director of Strategy and Regulation

Background and general approach

The open letter on the Future System and Network Regulation (FSNR) has a much broader scope than the equivalent open letter at this stage for RIIO-GD2. For comparison, the RIIO-GD2 open letter set out 5 principles through which RIIO-GD2 should operate. These principles set out broad points of design, such as the length of the price control, innovation, the role of competition, asset utilisation risk, managing uncertainty, incentives, and cost of capital. In total 37 questions were set out which were specific to a topic of regulation.

In contrast, the current FSNR open letter is much broader on the structure of regulation and has 4 questions, that address the basic structures of regulation. With this context, such a level of regulatory change would be very challenging to deliver before the start of the next price control in April 2026 in an effective manner (for context the RPI-X@20 and the move to RIIO took place between 2008 and the start of RIIO 1 in 2013 – a period of 5 years).

It is SGNs' view that this is a critical time for the industry, and that introducing significant regulatory change at an accelerated pace would significantly increase the risk of poor regulatory outcomes for customers and increase the regulatory risk for investors. Both would undermine networks' ability to deliver net zero in a timely and cost-effective manner.

An important lesson from RIIO-GD2 was that the final guidance document was released too close to the end of the process. The limited guidance at the start of the business plan and significant late changes in the guidance led to rushed adjustments and inconsistencies between networks. These inconsistencies reduced the comparability of business plans and significantly increased the complexity of the business plan process for Ofgem. Introducing significant regulatory change at an accelerated pace would magnify this issue and risk amplifying inconsistencies between networks and increasing the regulatory burden that the change is looking to avoid.

To implement the scale of change potentially considered in the open letter, we believe that the existing price control would have to be extended for a minimum of a further 2 years, a process that would introduce its own challenges. Alternatively, we should consider this as an open letter for the GD4 price control that is anticipated to start in 2031.

Response to Key Questions

1. Do you have any views on the strategic issues we will face in the development of the next price control review process?

SGN agree with many of the strategic issues that have been identified by Ofgem within their open letter and SGN agrees with the extent of change and with the uncertainty around the pace of change. SGN also agrees with the need for 'whole-systems optimisation' and emphasis that this needs to include all energy – gas, electricity, transport, and heat – and needs to include both transmission level and distribution level investment.

Whilst we agree that these strategic issues are important, and the uncertainties associated with them are considerable, we also need to recognise that the degree to which they will be realised and resolved in the next price control period will depend on the customer. Those customers will need to accept major changes to the way energy is transmitted, and consumed, as well as the associated costs. Currently, customer acceptance of this level of change cannot be taken for granted or assumed. In the discussion on strategic issues, there was very limited focus placed on the end consumer despite them being a critical part of the story.

The importance of the customer is particularly significant in the case of more vulnerable and/or marginalised customers and how those customers are taken on a journey to decarbonised energy. There is a significant risk that they will be disadvantaged as a result of not being able to adapt for social, personal, or financial reasons to the new energy system.

The importance of the customer feeds across the outcomes that the next price control will need to deliver. A customer-centric perspective places a financial premium on minimising disruption, particularly in the home, and minimising local planning impacts. The extent to which these factors could drive network requirements or constrain the pace of investment in infrastructure should not be underestimated.

Accordingly, we need to maintain our awareness that the decarbonisation pathway will be subject to change, both in terms of end-state realised and timing to deliver that end-state. Whilst there is this level of flux, we need to maintain investor confidence and keep options open. There is a risk that significant customer harm could arise if it is decided that we should under-invest in the resilience or safety of an asset until there is confidence that robust alternatives, that are supported by the consumer, are in place.

Currently, for the decarbonisation of domestic and industrial heat, we do not have a robust alternative that is clearly supported by the consumer in place. It is important, therefore, to recognise the 'insurance value' that an established and well-functioning network provides in terms of resilience and security of supply. This resilience and insurance value is necessary given the current uncertainty surrounding alternative sources of heat that may not be proven technically, socially viable, financially realistic, and may not be politically achievable. On this basis, it is essential that existing assets are maintained and invested in to maintain

customer safety. This is particularly important for the gas networks where the investment necessary to maintain safety by replacing the iron and steel mains also supports options for decarbonisation of domestic heat through hydrogen, supporting the development of the least-cost pathway.

2. Do you have any views on the case for change we have outlined?

Given the extent of change involved in the energy transition, SGN agrees that it is important to keep the regulatory structure under review and to challenge whether the components of the regulatory structure deliver the best customer outcomes.

It is also important that regulatory structures remain flexible and responsive to change. In RIIO-GD2 greater flexibility was introduced with an increased focus on indexation, volume drivers, and reopeners. This has provided greater responsiveness of the price control settlement to a changing environment.

The periodic review of the business planning process also provides a key focal point from which to validate with customers whether that progress is appropriate and to secure feedback on whether the changes are appropriate for the customer we serve. SGN's perspective is that the RIIO framework has been successful in driving greater cost-effectiveness, attracting investment, and achieving better customer outcomes than would otherwise have been the case. We believe that this positive customer outcome has been substantially delivered through the incentive mechanisms and the focus on innovation that was introduced as a result of the RIIO framework.

SGN considers that the case for change can be separated according to whether the investment is anticipatory (investment ahead of demand) or not. As the pace of change increases and we progress to a net-zero endpoint, the pace of investment increases as well as the need for anticipatory investment. For example:

- **Where the pace of investment increases but the investment is not anticipatory:** The principal risk is that capacity of the regulator is insufficient to complete an accurate assessment of economic efficiency in a timely manner. As a result, the consumer may not get appropriate value in terms of the efficiency with which that investment is delivered, or the investment itself is not sufficiently funded and the consumer is exposed to under-investment. This is a concern of capacity and SGN believes this is largely independent of the regulatory structure.
- **Where the investment is anticipatory:** There is still a concern regarding the accurate assessment of economic efficiency of project delivery, however, there is an additional concern regarding asset utilisation. The reasons for a poor customer outcome (characterised by either under or over-investment) can be due to actions taken by the networks in a poor assessment of demand, or due to unanticipated events outside of the networks' control. The balance of risk between networks and consumers in these instances is an important area of debate, and it is important that there is a clear understanding of how risk and associated costs should be allocated.

For gas networks, there is the potential for anticipatory investment so that the network is effectively positioned in advance of policy determinations on the use of hydrogen for domestic heating. We would support a common approach across networks to establish a consistent framework through which different investment options (i.e. in anticipation of hydrogen or not) should be considered.

The second scenario for gas networks is that reducing demand could render some investments unnecessary as demand in future years will undermine today's investment case. SGN's view is that this risk can easily be overstated because the majority of investment is focused on maintenance, asset health, and reliability. It should be stressed that whilst there is gas within the network then safety standards have to be maintained. As such, reducing investments which are determined by safety requirements can only be considered when there is a clear and fully committed pathway for removing customers from the network, enabling the network to be decommissioned.

Where an investment is primarily driven by safety requirements, the exposure of reduced demand on that investment decision should only be considered when there is certainty that the asset will no longer be required. In the absence of legislation that requires customers to be disconnected from the gas main, and the absence of a compelling alternative for domestic heating that is supported by the customer, then safety-related investment must be maintained. Accordingly, SGN does not consider uncertainty in demand for gas is a significant consideration for project-level investment decisions in the next price control period until clear policy decisions are taken. In the open letter, Ofgem identifies features of RIIO-GD2 that may benefit from adaptation to the strategic issues identified, these are all addressed below.

Process

We agree that the regulatory process is resource intensive, however, these are complex issues and any regulatory or investment process will be resource intensive for all parties involved (whether regulators or networks). It is SGN's view that the regulatory process can be significantly improved to deliver a better outcome. Specifically, SGN considers that the regulator and networks can work together to deliver early-stage process improvements which will improve the consistency of the plans submitted to the regulator and this will reduce the regulatory burden associated with inconsistent plans and time required to bring submitted business plans onto a consistent basis.

Specifically, key areas where improvements can be made include:

- **Consistency between business plans.** In RIIO-GD2 there was not a clear definition of a high-quality plan and how the business plan should be structured. Networks interpreted broad guidance to the best of their ability and as a result, plans were submitted on an inconsistent and incomparable basis. This necessitated a time-consuming process of unravelling the differences to provide a point of comparability, increasing regulatory burden and distracting resource from appropriate challenge and analysis. Working with networks to establish clear and consistent guidance on how information should be structured and presented and a clear assessment as to what constitutes a good business plan would help provide clarity, support comparability for customer groups and reduce the regulatory burden.
- **Consistency in approach to uncertainty.** In RIIO-GD2 there was inconsistency between plans on how uncertainty should be represented in the baseline plan and where it was more appropriate for uncertainty to be borne by networks or by the consumer. As a result, some plans were presented with no uncertainty, and some on a most likely outcome, and proposals for managing uncertainty were discussed with consumer groups that did not later transpire. Establishing at the outset the areas and mechanisms through which uncertainty will be managed and how it should be represented within networks' business plans would again support more effective customer engagement, promote comparability and reduce regulatory burden.
- **Consistency in the definition and allocation of project risk.** In RIIO-GD2 there was no real discussion on the appropriate way risk should be considered for capital or IT projects according to their stage of development in the project lifecycle or level of innovation. It is widely recognised that projects that are more innovative (such as H100 or SGN's Remote Pressure Management PCD), at an earlier stage of the development cycle (capital projects that may still require planning permission), or have a lower commercial readiness (such as the cyber IT and OT projects at the time of submission) will be exposed to a higher cost uncertainty than a project at a later stage in a development cycle, using established technologies. Having a consistent approach to the assessment of and the allocation of risk across different project types and across networks is important in supporting transparency and consistency. It is also important to have a clear understanding of the exposure should the risk not be realised or if it exceeds initial estimates, this is important to ensure an appropriate balance of risk between customer and investor. This is particularly important as we move to more innovative projects necessary to deliver net zero.
- **Consistency in the role of customer engagement for informing the plan.** In RIIO-GD2 we believe that although our plan was significantly improved through the work of the customer engagement group, some proposals were removed in their entirety (costs and workloads were removed) and other proposals were lost as the plans were sanitised through the Totex benchmarking model. Under the benchmarking approach, proposals to support a better customer outcome, which were supported by our stakeholders, were reflected as an 'inefficiency' in a benchmarking process that did not have the granularity to reflect all outputs within its cost drivers. This created a disconnect between the expectations of the consumer groups and the final determination and disincentivised ambition for better customer outcomes. Having a consistent understanding of where a well-evidenced customer expectation will be permitted as bespoke outputs outside of the benchmarking model would enable greater clarity on where the customer voice can have a material impact and maintain the customer at the centre of the business plan.

We are cautious that there could be a superficial attractiveness in advocating a significant change to the regulatory model that shifts resource intensity between either bodies or time periods without addressing the underlying root causes. It should be clear in any process that such steps will move, rather than address, the regulatory burden that has been identified.

We note that in the open letter Ofgem cites 'the information advantage' that networks have over them as one of the process challenges. We strongly refute this characterisation as Ofgem are underplaying the information benefits it has from being able to scrutinise historical actual costs from 8 different licence areas (for gas networks) and the benchmarking models that are deployed to determine efficiency. The value of this comparative analysis, other comparative methodologies, detailed project assessments and the authority's ability to request data and information should in principle place Ofgem in a stronger position relative to networks that only see their own cost evidence. In addition, Ofgem is able to introduce strong incentives to reward efficient and transparent cost estimates and penalties for networks that obscure or mask their cost data.

During the GD2 process, SGN provided more data and aimed for transparency in the level of detail provided (SGN supplied engineering justification papers for all projects with a value greater than £0.5m). This was provided to support the goal of transparency and a well evidenced business plan. It is our view that at the draft determination stage of the RIIO-GD2 business planning process, this additional data and increased transparency carried a penalty of increased scrutiny and increased regulatory burden relative to other networks. This was a counter-intuitive outcome that seemed to incentivise the creation of information asymmetry rather than recognise networks that actively reduced the information advantage that Ofgem has identified. As a network, we are still perplexed by this outcome and the implications for future regulatory cycles.

We agree that there are significant benefits to be realised from improving the network regulation process, but do not consider this indicates a need for wholesale regulatory reform. It does, however, suggest a requirement for Ofgem and networks to work together at an early stage of the business plan process to ensure there is consistency in how information and business plans are

presented, in the approach to uncertainty, in the allocation of risk and consistency in the role of customer engagement in informing the plan.

Structure and form

We agree with Ofgem's assessment that the RIIO framework has the potential to provide the appropriate balance of better outcomes at the lowest cost. We think that this framework can also support whole-systems outcomes as well as network-specific outcomes. As such, we would caution against the assumption that the regulatory design may act against whole-systems outcomes.

Rather, barriers to whole-systems typically have their roots in network obligations (licence, safety and customer obligations) that licensees must deliver. They are also rooted in the understandable reluctance on the part of networks to entrust the delivery of those statutory and licence obligations to a third party over which the networks may have limited control and require complex and difficult to administer legal agreements to govern, and/or in respect of which licensees may have already incurred costly development work.

We do consider there to be an important role for the Future System Operator (FSO), once it is established, in determining where there are whole-systems trade-offs and for bringing the parties together to confirm the allocation of deliverables, the timing of those deliverables and the consequential impacts for the counterpart should those deliverables not be achieved. It is SGN's view that this co-ordination role constitutes one of the key strategic functions of the FSO and potentially their local energy equivalent.

Balance of Risk

We acknowledge that the price control process requires decisions to be taken before necessary information is fully available, however, we would note that there are several mechanisms within the existing price control toolkit through which risk can be managed and many of these have been introduced or have had their role enhanced during RIIO-GD2. These include:

- New volume drivers were introduced, these included volume drivers for network connections which have allowed us to adjust our forecasts according to the changing economic outlook.
- Increased use of evaluative price control deliverables (PCDs) for large capital projects so that if the output is not delivered then allowances are returned to customers and can be subject to an efficiency assessment.
- The use of mechanistic PCDs for major programmes of work such as Repex, so that allowances are returned or unfunded if delivery exceeds specific tolerance bands.
- Tighter specification on the use of risk trading within the NARMS mechanism to support risk trading between equivalent assets.
- Improved indexation of factors that cannot be appropriately controlled or mitigated by the network, such as the indexing of real price effects and key financial parameters.

We also note that an increasing number of incentives are penalty only, and where there are financial awards available, they have been recalibrated to reduce the value and make them harder to achieve.

Accordingly, we struggle to recognise the basis of the statement that the 'judgement on the allocation of risk which have predominately turned out in favour of network companies'. Rather we note that a lot of new structures have been introduced in RIIO-GD2 and, after only one year of operation, it is too early to come to a conclusion as to their impact, which in many cases will only be fully realised at close-out. We therefore would like to understand the basis of this statement given the new RIIO-GD2 structure and the recalibration of risk undertaken at that time.

SGN also note that within the regulatory structure, there appears to be a lack of clarity regarding the objective of risk management. In our RIIO-GD2 business plan submission, we took the approach that uncertainty mechanisms should be proposed for risks that SGN could not directly control rather than looking to predict the outcome and bake them into the underlying price control, which was a recognised issue for RIIO-GD1. Some, such as volume drivers for new connections and volumetric PCDs such as electric vehicles were accepted, while others, such as volume drivers for reinforcements, were rejected. The majority, however, were criticised by the RIIO Challenge Group who had an alternative perspective on where risk should reside.

Accordingly, we think it is very important that there should be clarity of expectations on where risk should reside:

- If a risk is outside of the network's control and resides with the network, then the expectation should be that either the variance is not significant, or that the realisation of that risk (the positive and negative impact) should balance out over the long run.
- If the risk is outside of the network's control and it is a significant value (such that a difference between out-turn and forecasts could materially impact network revenues) then it should be captured in one of the mechanisms set out above so that customers are not adversely impacted, however, the allocation of risk needs to be symmetrical.

- If there is a risk that is within a network's control, and there is a concern of bias, then this is a matter initially of consistency in definition and allocation of risk (as set out above) and then secondly of calibration. This is necessary to ensure that poor definition and poor calibration are not conflated with effective risk management, an outcome that should be encouraged.

As such the management of risk is a design factor associated with the regulatory mechanism. As of itself, we do not consider the management of risk to indicate the need for a fundamental redesign of the regulatory process.

As set out above, the area that we think does however merit much closer scrutiny is the definition and allocation of project risk. This is the risk associated with the project as it moves between project phases and we think it is important that there should be a consistent understanding regarding the appropriate approach to funding risk according to the stage of the project, along with the interaction between risk and contingency. In the latest version of the reopener guidance, we are encouraged there is reference to the best practice guidance produced by the Infrastructure and Project Authority. Our view is that this needs to be adopted across the price control structure and there needs to be confidence that this will be applied in a consistent manner. Accordingly, the guidance needs to be worked through in a manner appropriate for network company projects to ensure a consistent application and reporting definition; otherwise, there is a risk of confusion, lack of transparency and duplication of contingencies and risks.

The second aspect that should also be clearly set out and understood for project risk above a certain size is the implications of either cost overruns or underruns. How these are treated will change the incentive properties of the project. For example, it could be that: (i) they are all attributed to the project; (ii) they are all recovered ex-post by the consumer; or (iii) they are shared. Each will have different incentive properties, but each needs to be based on a common agreement of where risk is appropriately reflected in the first instance.

Scope

We agree that the FSO has an important role in helping to guide network regulation by identifying where new assets are required and supporting whole-system outcomes, however, we believe that this insight is likely to be at the national level rather than a local level.

Asset investment at a local level is likely to be determined by incremental growth of local and neighbourhood demand and requires close alignment between local networks and local authority planning offices. This approach was supported at a recent Local Energy Institutions and Governance workshop, where Ofgem indicated a desire to avoid top-down planning decisions.

The other important role of the FSO is potentially in the coordination of a zonal approach to either commissioning hydrogen assets or decommissioning gas assets. Both are likely to require national coordination to ensure that demand and supply are calibrated, and that customer supply resilience is maintained.

SGN also considers that there should be boundaries placed on the role of the FSO, and we do not believe it appropriate for the FSO to be the primary body responsible for the determination of whether an investment is considered value for money, whether the risk allocation in a tender is in the customer's interests, or how contractual disputes should be evaluated. It is SGN's view that these financial questions should only be determined by the economic regulator that has clear vires set in statute to do so.

Ofgem has clear duties to the interests of current and future customers, balancing these competing demands will become increasingly more challenging as we progress towards net zero and investment decisions become larger in scale and carry greater risk. It is SGN's position that calibrating the level of investment, the level of innovation and the exposure to risk that current and future customers are exposed to must reside with Ofgem.

Different types of uncertainties

We disagree that in the next price control gas and electricity sectors will face different types of uncertainties in their standard operations. Rather, it is the scale of the uncertainties the sectors face which may vary, and as a result, place a greater emphasis on the upfront design and calibration of uncertainty mechanisms already utilised by Ofgem.

For investors, however, the gas networks are the only networks to have the longer-term existential risk of whether they will continue to have a role as a part of the decarbonised energy sector, however, managing that risk is currently outside of the scope of existing regulatory mechanisms and will need to be addressed.

SGN, therefore, do not see a strong case for having alternative regulatory structures in different sectors, rather we would be concerned that to do so could create a barrier to delivering whole-systems solutions that cross these sectors.

3. Do you have views on whether changes to the electricity or gas sectors mean we should consider alternatives to the approach taken in the RIIO-2 price control?

As set out above, SGN does not consider that the case for change is sufficiently compelling at this point in time to implement a fundamental reform of the regulatory system, and we have also identified that the timing involved in such a reform would need to be carefully considered.

Rather than fundamental reform, we have set out above that there are significant areas of improvement, where networks and the regulator could benefit from working together to improve clarity and consistency in the early stages of the price control to reduce the regulatory burden at later stages of the price control.

On this basis, we would caution against a decision to move away from periodic reviews. It is SGN's view that the periodic review process provides an important point of focus and re-calibration of the price control within a structured manner. The review provides a focal point for customer engagement and ensures that the price control package remains calibrated to their needs and requirements and new concepts and approaches can be tested.

If Ofgem was to move away from periodic reviews in its entirety, then it would be very important for investor confidence for Ofgem to carefully set out the basis on which network price controls would be reopened or the basis on which a review would be carried out in future when the calibration of the price control was clearly not appropriate.

Alternatively, Ofgem may choose to move towards a more targeted approach, where specific decisions are outside of the periodic price review process. We agree that this can be appropriate, and the use of the reopener mechanism within RIIO-GD2 for net zero projects, cyber IT and cyber OT, and non-operational IT capital expenditure are examples of how reopeners can provide flexibility and agility.

However, it should also be recognised that reopeners may not be designed perfectly. We have seen for example the increased focus on digitalisation brought about by the aspiration for open data, however, the primary reopener excludes operating costs which is a critical requirement to move data from closed data to open data in a manner that is consistent across the industry. As such whilst we agree with a more targeted approach to decision-making, we also believe that a targeted approach benefits from a periodic review in which to define its scope.

SGN have considered all the options for future variants of regulatory frameworks proposed by Ofgem to determine which best suits the next price control period:

- **Continued use of periodic reviews.** For the reasons set out above this is a clear preference and if periodic reviews were to be discontinued it would need to be replaced with very clear guidance that sets out the basis of when a review is called and the rights of networks to require a review to be carried out. It is our view that more targeted assessments can be effectively incorporated into a periodic review process.
- **Alternative ex-ante incentive regime.** We do not believe that artificial simplification is in customers' interests, particularly where network requirements are rapidly evolving. In RIIO-2 Data & Digitalisation, Cyber and storm resilience (in ED) were significant developments. We think that it is important to facilitate these developments, which a simplified regime may not deliver.
- **Greater user/stakeholder participation.** Whilst we welcome greater stakeholder participation, given the complexity of the topics and the trade-offs that are sometimes required it can be a challenge for any user or stakeholder participation group to have the depth of knowledge required to make an informed decision. Given the complexity, there is a risk that a user / stakeholder group will have to draw on industry representatives which can make it very challenging to differentiate between commercial positions and wider market benefits. As such, there are diminishing returns to stakeholder participation as the complexity increases and we would need to be clear on the basis on which 'stakeholder participation to determine investment' would deliver a better outcome compared to an experienced regulator. We consider there to be a significant risk that it adds a further step into the process and reduces accountability.
- **Ex-post regime.** There is a strong evidence base as to why ex-post regulation does not deliver efficient outcomes. Ofgem's own assessment in 2009 provided a compelling assessment and some quotes have been provided below. It is our view that Ofgem would need to present an equally compelling case on what has changed since this assessment and why the outcome will be different by moving to ex-post regulation this time around.

*'The weakness of ex post regulation in constraining excessive pricing is a key finding that applies to all energy networks in Great Britain. To move away from ex ante regulation would therefore require strong evidence of countervailing benefits to match the dis-benefit to consumers of higher prices.'*¹

'With regard to GB networks, our conclusions imply that there is no advantage to ex post regulation in regards to operating efficiency. Although quantification is outside the scope of this study, it seems

¹ [The case for ex post regulation of energy networks](#) – Ofgem commissioned report from LECG (2009), Section 1.22 pg. 8

*clear the existing system already provides strong incentives. Moreover, incentivising operating efficiency at the expense of consumers seems inconsistent with Ofgem's statutory duties.'*²

*'There is relatively little scope for lowering the regulatory burden of network regulation in GB by a shift towards an ex post regime.'*³

*'Based on our findings, there do not appear to be significant benefits to consumers from moving from an ex ante form of control to an ex post form of control. A move would be more beneficial if consumer price signals were required to incentivise innovation. However, in the energy sector, it is not consumer demand that drives the fundamental changes required of the sector, but the need to address climate change. Secondly, the monopoly nature of networks and low price elasticity and uniform nature of networks is likely to diminish the opportunity and incentive to innovate under ex post regulation.'*⁴

It needs to be recognised that substantial changes in the regulatory process risk undermining confidence in the regulatory regime. Historically, Ofgem has benefited from a strong reputation with credit rating agencies which has supported a lower cost of capital. There is a risk that this could be undermined by unsubstantiated changes in regulatory structure, with implications for the cost of financing.

Moving allowances to an ex-post determination, for example, significantly increases the financial risk associated with that determination relative to an ex-ante determination where access to allowances is clearly understood prior to investment. This will need to be reflected in the reference points that underpin the cost of debt and the cost of equity calculation, and there will be an associated increase in the cost to consumers in addition to the efficiency impact cited above.

In contrast, the impact of increased use of uncertainty mechanisms will be more specific to the design of those uncertainty mechanisms and how risk is allocated. We need to ensure that uncertainty mechanisms are designed in a manner that provides sufficient confidence to invest with a risk profile that is broadly aligned with the core operating business. If the uncertainty mechanism's risk profile is substantially different from the overall risk of the rest of the price control, the WACC for the price control will need to accommodate the increased risk or an alternative cost of capital will be required for that investment.

The risk associated with reopeners is an important area of complexity that needs to be carefully considered. If the reopener is too late in the process, then significant costs can be incurred with limited confidence that it can be recovered. This lack of confidence will incentivise reducing expenditure during the critical first planning stages of a project and this may increase the risk of later delivery stages. This contrasts with reopeners that occur too early in the process where there may be insufficient confidence in the design of the project to determine an economically efficient cost and associated risk. SGN would support greater dialogue on the approach to uncertainty and how greater phasing of expenditure can be used to achieve a more effective outcome.

4. Are there any broad frameworks or options that you think we should consider, including variants and alternatives to those we set out?

There are challenges for all models of regulation, and the benefits and consequences of adopting one model or another need to be carefully considered, assessed, and consulted upon. In the last major assessment of policy RPI-X@20 the debate ran over two years and involved a significant number of consultations, working groups and dialogue⁵. It is SGN's view that an equivalent debate would be necessary to move away from the now-established RIIO-model. This extensive engagement is necessary to evaluate alternative approaches, assess their impact and review how they may be implemented in practice and test the concepts developed. This level of assessment is necessary to maintain investor and customer confidence and is outside of the scope of a short four-week consultation period. SGN would be supportive of such an engagement exercise, however, prior to this, we think it is important to have a clear definition of the problem that needs to be solved and where this problem is most manifest.

SGN also recognise that there are challenges in creating appropriate regulation for managing the transition to net zero. Significant progress can be made in the existing regulatory structure to improve the efficiency and responsiveness of existing uncertainty mechanisms to improve the ability of the regulatory package to adapt to a changing operational environment. It is our view that significant improvements can be made through;

² Ibid, Section 1.34 pg. 11

³ Ibid Section 1.39 pg. 12

⁴ Ibid Section 1.43 pg. 13

⁵ <https://www.ofgem.gov.uk/sites/default/files/docs/2008/01/rpi-x%4020-full-list-of-paper.pdf>

- Improved use of volume drivers. Greater clarity and consistency in the use of volume drivers will enable a more mechanistic approach to uncertainty, in a way that can be expressed within the licence. We would encourage a discussion on how fixed and variable costs should be treated under the volume drivers, and how unit costs should be defined (in RIIO-GD2 often they were a product of totex benchmarking model which created anomalies in unit values). We also recognise that there is a risk that the unit costs may be incorrectly set, which may be detrimental to the network or the consumer, as such an appropriate recalibration structure may be required.
- Greater flexibility on the use of reopeners. In RIIO-GD2, the use of re-openers around net-zero has more flexibility, however other reopeners are unnecessarily constrained such as the 'non-operational IT capex' reopener which excludes operational costs, and the 'HSE Policy Reopener' which is limited to repex and emergency and repair costs. We think that there is an important debate to be had on where constraints on reopeners add value and where they hinder adaptability.
- Improvements in the process for re-openers. We recognise the regulatory burden that reopeners place on Ofgem for coming to a determination. We would encourage a more formalised process through which costs are presented, evidenced and their efficiency is determined to help reduce the regulatory burden. These requirements will vary between re-openers according to whether it is entirely ex-ante (i.e. an innovation or net zero project) or largely ex-ante (i.e. an operational reopener such as diversions or HSE Policy).

We have commissioned some independent work to explore opportunities and would welcome an opportunity to discuss the conclusions with you.

In addition, and as set out in our response to question 2, we think that there are significant benefits to be realised by increasing the comparability and consistency between business plans submitted. It is our view that working on a consistent basis between networks will reduce the regulatory burden at later stages of the business planning process and improve clarity and transparency. To achieve this, we think that it will be important for networks, regulators and customer bodies to work together at the earliest stage of the price control. Having early clarity and stability on the objectives and the parameters of the price control is critical to an efficient regulatory process.