Centrica plc
Regulatory Affairs
Millstream
Maidenhead Rd
Windsor
SL4 5GD
www.centrica.com

Joanna Gaches
Office of Gas and Electricity Markets
10 South Colonnade,
Canary Wharf,
London E14 4PU.

18 January 2023.

Sent by email to: joanna.gaches@ofgem.gov.uk

Dear Joanna,

RIIO-ED2 Statutory Licence Consultation

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

Our overall assessment of Final Determinations (FD) is that the RIIO-ED2 price control settlement is structurally biased in favour of the Distribution Network Operators (DNOs). In our response to the consultation on Draft Determinations (DD), we explained why the proposals needed to be improved to strike a better balance of risk and reward between consumers and the DNOs, and how that balance could be achieved. We do not believe that the proposals have been sufficiently rebalanced.

We recognise that improvements have been made in some of those areas that we highlighted needed improving[1]. However, there still are several aspects of the proposals that are calibrated in ways that represent structural bias in favour of the DNOs; most of our concerns have not been satisfactorily addressed. Where the proposals have not been improved, we consider that the relevant decisions have not been sufficiently evidenced, explained or justified given the evidence that we submitted in our consultation response. Among other things:

- **The allowed returns remain unnecessarily generous.**
- **The revised calibration of the Complaints Metric increases the financial value of the performance headroom that is embedded in the targets.**
- **The approach to setting targets for the Interruptions Incentive Scheme has not been justified and the revised targets still provide the companies with significant protection.**

We discuss these issues below.

[1] For example, Ofgem has increased the annual performance gains some DNOs need to achieve to avoid penalties under the Interruptions Incentive Scheme.

The allowed returns remain unnecessarily generous:

Cost of debt:
At DD, Ofgem's proposed an approach to setting debt allowances that included disregarding the 'halo' effect and providing an infrequent issuer premium to three DNOs. We disagreed with these aspects of the proposal because we considered that consumers would be required to fund debt allowances that were higher than necessary. We estimated that disregarding the 'halo' effect and retaining the infrequent issuer premium would increase costs to consumers by £91m and £9m respectively.

The proposal to disregard the 'halo' effect has been confirmed. The infrequent issuer premium has been retained but will be provided to an additional eight DNOs, thereby increasing the number of DNOs that will benefit to 11 (of 14). We estimate this decision will increase costs to consumers by a further £30m[2].

We still do not think the need for the 'infrequent issuer premium' (IIF) has been robustly justified. All DNOs except ENWL have the option of manging their debt arrangements on a consolidated group basis and, so, should not be treated as infrequent issuers and should not need additional allowances.

Also, Ofgem has justified applying the IIF at the licensee level, to maintain consistency with the notional licensee approach adopted elsewhere in the price control. We are not convinced by this argument. Consistency need not be maintained for the sake of doing so when alternative approaches are justified. We consider managing their debt arrangements on a consolidated group basis to be a tool that the companies could employ to efficiently manage their debt costs. Treating companies as infrequent issuers could weaken the incentive for companies to explore employing that tool and/or could require consumers to fund debt costs that are inefficient. We remain concerned that consumers will be required to provide funding that unnecessarily over-remunerates the DNOs.

Cost of equity:
At DD, Ofgem's proposed an approach to setting the cost of equity that included issuance costs that were described as "even generous". Also, the beta estimates were not reduced to reflect the reduced systematic risk and no weight was placed on the cross-checks. We disagreed with these aspects of the proposal because we considered that consumers would be required to fund allowances that were higher than necessary. We estimated that not setting the point estimate of the cost of equity as the average of the cross-checks would increase costs to consumers by £457m. Ofgem did not change its approach at FD.

Equity issuance costs:
Ofgem states there were no objections to the assumption[3]. This is incorrect. In our response, we highlighted that Ofgem described the proposal as "even generous" and we, therefore, considered it to be inefficient. At DD, Ofgem did not provide any evidence to justify the assumption of 5% for the costs of raising new equity. Ofgem still has not provided any evidence or robustly justified the

[2] Based on the revenues that were published at DD, which have been used for consistency.
[3] Final Determinations Finance Annex paragraph 10.88.

assumption. We remain concerned that consumers are required to fund allowances that have not been demonstrated to be efficient.

Beta adjustments:
The approach for deriving beta is reasonable except that is does not account for the reduced risk in RIIO-2 relative to RIIO-1 as a result of the changes made for the RIIO-2 price controls. Maintaining consistency with the value for the transmission and gas distribution price controls results in beta for the DNOs being over-estimated because the reduced risk was not taken into account for those sectors. This issue was raised in our response but it has not been addressed. We consider this to be an example of structural bias in favour of the DNOs in the RIIO-ED2 settlement.

Cross-checks:
We continue to disagree with Ofgem not placing any weight on the evidence derived from the cross-checks. It is not in consumers' interests for no weight to be placed on this evidence given that, according to Ofgem, the evidence suggests that the point estimate derived from the Capital Asset Pricing Model (CAPM) is higher than the true value of the cost of equity[4]. 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.

The revised calibration of the Complaints Metric increases the financial value of the performance headroom that is embedded in the targets:

At DD, Ofgem proposed to set the target for the Complaints Metric at 2.8. The average score during the four years up to and including 2020-21 was 2.2. We disagreed with the proposed target because it did not embed the improvements the sector made during RIIO-ED1 (as was done for the Customer Satisfaction Survey) and, therefore, contained headroom. We explained that the headroom in the target creates the opportunity for the DNOs to choose to allow performance to degrade to a degree below current levels but without being penalised. We estimated the financial value of the headroom to be worth £17m over the RIIO-ED2 period.

Ofgem does not agree with our concern because the DNOs improved performance during RIIO-ED1 despite consistently out-performing the target[5]. The target has been confirmed at 2.8 and the financial value of the headroom in the target has increased to £31m[6].

It is factually correct that setting the target below performance achieved during RIIO-ED1 creates the opportunity for the DNOs to choose to allow performance to degrade to a degree but without being penalised. Allowing performance to degrade (e.g. by investing less than needed to maintain current performance) without incurring penalties can be a rational choice. It cannot be guaranteed that the network companies will continue to seek to improve performance if that choice is available to them and, as such, our concern is valid. Incentives should not be calibrated in ways that create

[4] Final Determinations Finance Annex paragraph 3.135.
[5] Final Determinations Core Methodology paragraph 5.46.
[6] This is a result of the incentive strength being increased.

the opportunity for network companies to make that rational choice because it is not in consumers' interests. This is an example of structural bias in favour of the DNOs in the RIIO-ED2 price control.

Ofgem states that it is appropriate to include performance data from earlier in the RIIO-ED1 price control when setting the RIIO-ED2 target. Doing so means that the statistical outliers that Ofgem thought necessary to exclude when setting the maximum penalty are included in setting the target. The target is less challenging than it otherwise would be because the outliers have been included. In the absence of Ofgem robustly justifying why including the outliers when setting the target is in consumers' interests, we think that the statistical outliers should be excluded when setting both the maximum penalty and the target. This is another example of structural bias in favour of the DNOs in the RIIO-ED2 settlement.

The approach to setting targets for the Interruptions Incentive Scheme has not been justified and the revised targets still provide the companies with significant protection:

At DD, Ofgem proposed three changes to the methodology for setting targets for the unplanned Customer Minutes Lost (CMLs) element of the Interruptions Incentive Scheme (IIS). The changes are removing the ratchet, setting targets reflecting each DNO's performance instead of using frontier performance and halving the annual improvements that the companies would be required to achieve to avoid penalties. Each individual change softened the targets. We raised concerns about the changes because, for various reasons, the need for the changes had not been robustly justified. We estimated the proposed changes would provide the sector with substantial financial protection worth £215m over the RIIO-ED2 period.

The proposals to remove the ratchet and to set targets reflecting each DNO's performance have been confirmed. The improvement factors for some DNOs have been increased. The confirmed targets are still less-challenging targets than those that would have been produced by the original methodology. The confirmed targets provide the sector with financial protection worth £167m[7].

Setting targets reflecting each DNO's recent performance:

The decision to set targets reflecting each DNO's recent performance seems to have been made, in part, to avoid some DNOs starting RIIO-ED2 in a penalty position. If this is correct, we disagree with the decision. We continue to believe that it is not necessary to set targets to avoid any DNO starting RIIO-ED2 in a penalty position because the marginal incentives to improve performance to incur a smaller penalty or to earn a larger reward are the same.

Ofgem does not consider reverting to the original methodology appropriate because not reverting removes the significant step change between the performance delivered by the poorer performing companies in RIIO-ED1 and the target for the first year of RIIO-ED2. Also, Ofgem considers the change necessary to avoid setting unachievable targets for some DNOs[8]. Ofgem's evidence[9] shows that four of the five poorest performing DNOs[10] earned rewards that significantly exceed

[7] Based on the targets published in the company annexes.
[8] Final Determinations Core Methodology paragraph 6.78.
[9] Final Determinations Core Methodology page 166.
[10] SPMW, SPD, SSES, SSEH and ENW are the DNOs for which the highest proportions of headroom were embedded in the targets proposed at DDs, compared to the targets produced by the original methodology.

funding employed to deliver that performance. As a whole, the sector has earned rewards that dwarf the funding employed to deliver performance.

Ofgem has not presented analysis that explains the extent to which performance delivered by the poorer performing DNOs during RIIO-ED1 was due to factors beyond their control. This analysis would provide some insight into how much scope there is for further performance improvements. Ofgem has also not presented any evidence to explain why it thinks the step change will render targets unachievable. This evidence would have been helpful because, in isolation, the step change does not automatically render targets unachievable. Indeed, some DNOs have achieved step changes in performance[11]. It is for these reasons that we do not think that Ofgem has justified the decision to set targets reflecting each DNO's recent performance, especially given the substantial financial protection to the sector.

Convergence:

Setting targets reflecting each DNO's recent performance instead of using frontier performance to set an industry benchmark and, thereby, no longer aiming for performance convergence, is a fundamental change in the assumptions underpinning the IIS. At DDs, Ofgem stated it was considering whether DNOs should be able to improve at the same rate (at a minimum) and that performance will converge over time[12]. However, Ofgem now considers absolute convergence in performance is unlikely to be achievable[13]. Ofgem has not presented any evidence to explain why it now thinks convergence is unlikely and, therefore, has not justified over-writing this fundamental design assumption. Ofgem has not demonstrated that this change is in consumers' interests.

The increased reward cap:

While we do not comment of the specific level of the cap on rewards, we consider the justification for increasing the cap to be confused. Ofgem states:

> *We recognise that whilst the cap limits the cost to customers, we agree that it potentially restricts the amount of efficient investment that can be made by DNOs, and thus the number of improvements that can be made before the cap is reached. We also consider that poorer performing DNOs who drive significant performance improvements over RIIO-ED2 could reach the cap more quickly than they would under a larger revenue cap, which could prevent further performance improvements and the ability for these DNOs to catch up with the performance of frontier DNOs [...].*[14]

Concerns about targets being unachievable and the cap limiting performance improvements for poorer performing DNOs cannot rationally co-exist. The cap does not restrict rewards simply because of a large enough performance delta. The cap restricts rewards only if a DNO, poorer performing or otherwise, exceeds the target and achieves that level of performance beyond which no additional rewards can be earned. All other things being equal, softer targets make it easer for a DNO to achieve that level of performance beyond which no additional rewards can be earned. For a given cap, any concern about the cap limiting performance improvements for poorer performing DNOs should increase with targets being softened. We do not think that it has been demonstrated that setting targets reflecting each DNO's recent performance and increasing the cap are in consumers' interests.

---

[11] NGED and UKPN.
[12] Draft Determinations Core Methodology paragraph 6.56.
[13] Final Determinations Core Methodology paragraph 6.79.
[14] Final Determinations Core Methodology paragraph 6.37.

The combined impact of softening the targets and increasing the cap is the increase in the (unit) funding that the DNOs can access to deliver levels of performance exceeding the target. This could be considered be an indirect way of providing funding akin to quality-of-service (QoS) expenditure, which has been ruled out[15]. The debate about how target should be set and the level of the cap is also indirectly a debate about how and to what extent consumers should fund QoS expenditure. This demonstrates why it is necessary to consider efficiency from the consumer perspective.

In appendix 1, we summarise the ways in which we consider the proposed settlement is generous, embeds outperformance or provides the DNOs with significant protection against downside risk. 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

---

[15] Final Determinations Core Methodology paragraph 6.121.

Appendix: Generosity in the RIIO-ED2 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	• 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 an explicit 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 cost of debt allowances – appearing to provide an uplift on the index in order to match debt costs in-period with less weight placed indexation funding efficient costs over the long term. • 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 relative to RIIO-1 because of mechanisms introduced in RIIO-2. • when setting the allowed return on equity - effectively 'aiming up' by not adjusting for expected outperformance to take account of the systematic bias in favour of the DNOs in other areas of the settlement.
Returns	• when designing the Returns Adjustment Mechanism – setting trigger thresholds at levels that provide insufficient protection against systematic outperformance.
Complaints Metric	• when setting the baseline target – embedding headroom by setting the target below current levels of performance. • when setting the baseline target – including outliers in the data used to derive the target.
Interruptions Incentive Scheme	• when setting targets – softening the targets by removing the ratchet. • when setting targets for unplanned CMLs - softening the targets by abandoning the approach based on an industry benchmark but without providing evidence to support the decision.
Other	• 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 ex-ante load-related allowances – deciding to revisit allowances only of the DNOs have not spent more than 80% of their non-volume driver allowances and not setting targets or allowances for that component of expenditure. • when developing the treatment of expenditure for severe weather 1-in-20 events – by assuming all expenditure occurred will be efficient.