

Appendix – UK Power Networks’ response to questions

Q.1. What should the role of the ‘consumer voice’ be and through what institutions and processes should it be channelled?

The role of consumer engagement groups should be critically assessed, and their roles and responsibilities updated given the wider reforms being proposed by Ofgem. The introduction of RSPs and regional plans would remove a large part of the consumer engagement out of the price control process. Material issues such as the trade-offs between current and future consumers would need to be wrapped up as part of the regional planning process including local authorities and other stakeholders. The voice of consumers in networks price controls would naturally therefore focus more on connections, reliability, and service delivery in the main. Customer engagement groups’ terms of reference should therefore evolve accordingly to focus on the matters high on consumers’ agenda and not focus on matters that are driven by legislative standards and regulations e.g. network asset risk modelling.

In our view the following elements are important to consider:

- Licensee reward must be dependent on meeting the broad needs of consumers. This translates into metrics on customer service, on reliability, on cost efficiency and on all of the other elements of the consumer interest. The key advantage of the RIIO framework of regulation is that it delivers this alignment of consumer and shareholder interests.
- If the right regulatory incentives are in place, licensees will want to engage with consumer groups as much as possible in order to deliver improved consumer outcomes and maximise revenue. Licensees should therefore be free to engage with customers and stakeholders as it best sees fit, with a stronger focus on the delivery of measurable outcomes. This aligns to what Ofwat has recently put in place for PR24.
- Ofgem enhancing its own engagement with consumer organisations to improve its understanding of what customers care most about, what is achievable and how it can best be delivered. We recommend getting input at an early stage to improve the quality of regulatory design.

Q.2. How detailed could an independent, cross vector view become to determine future plans for periods beyond RIIO-2 and support effective use of the ‘Plan and Deliver’ model?

To be sufficiently detailed at electricity distribution, licensees need to take the lead on developing network plans and defining their needs. A regional system plan is not a substitute for an electricity network development plan. DSOs have a crucial role in taking regional system plans and advising on how the electricity distribution network needs to be enhanced to deliver the needs at lowest cost. The DSO ensures that network investment decisions are taken in the interests of consumers i.e. the lowest cost options are always taken free from any asset based bias. For DSOs to perform this task meaningfully, they require a thorough understanding of the condition and loading on the asset base. Independence of DSOs is critical to address any information asymmetry between network companies and Ofgem. They provide an effective layer of independent review, in addition to Ofgem’s scrutiny, to ensure network capacity is required and delivered cost efficiently.

Assigning clear accountabilities

It will be critically important that the roles, responsibilities and accountabilities of the FSO, RSPs and the DNOs are defined to allow effective operation and regulation of the new arrangements and that there are no grey areas regarding responsibilities which inadvertently change the risk profile of network companies.

Under the plan and deliver archetype, Ofgem describes the FSO determining the investment projects that will be undertaken on the network and procure the delivery of those projects. However, Ofgem also states that the responsibility for maintaining quality of supply will still rest with the DNO¹. Currently, it is unclear how the DNO mitigates both the risk of the wrong investments being identified and the non or substandard delivery of those investments which may impact on its obligation to maintain supply quality. This is one of the key issues that resulted in UK Power Networks establishing an independent and legally separate DSO under common ownership.

Ofgem's FSNR consultation suggests a stronger role for the FSO to strategically plan network requirements with the possibility that DNOs may not plan and deliver general reinforcement. Yet as Ofgem states in its Future of Local Energy Institution's consultation, it seeks to establish clear accountability for network planning under the DNO. We cannot see a credible arrangement whereby the DNO is told what solution is needed when and where by the FSO, and yet still holds accountability for network reliability and planning.

The case for anticipatory investment

Any large scale strategic anticipatory investment in networks must be demand led given the dynamics at distribution level. We recognise that there are a lot of voices from the industry calling for large scale strategic anticipatory investment to be allowed by networks. The reality is that all investment by its very nature is in anticipation of demand, otherwise we would experience unplanned power cuts due to network overloading. Therefore, we rationalise that commentators asking for large scale anticipatory investment are seeking the ability to make more speculative decisions about future network needs. The issue we have with this is that new demand from decarbonisation will not be spread evenly and there is no guarantee on when and where network constraints will occur. DNOs collectively have over 600,000 substations and 30 million network cables. Encouraging system-wide reinforcement without being demand-led would be catastrophic for customers' bills as it would jeopardise the benefits of a smart and flexible energy system (estimated to be up to £16 billion per annum²) and would exacerbate already stretched global supply chains unnecessarily. Future price controls therefore must:

- a) Protect customers from unnecessary network investment by having robust and independent network needs validated by RSPs in conjunction with other local stakeholders.
- b) Deliver network capacity at the lowest cost by having independent DSOs determining the optimal solutions for capacity free of an asset bias.
- c) Ensure that large scale strategic network investment (i.e. £20 million plus schemes), when it is required, is delivered efficiently by DNOs and monitored by Ofgem using Price Control Deliverables (PCDs). We do not believe this creates an undue burden on companies or Ofgem given that this scale of schemes is targeted. To enable this Ofgem should establish a streamlined process for licensees to receive ring-fenced PCD allowances for well justified anticipatory investment. This should use our ED2 Off Gas Grid PCD as a template.

¹ [Consultation: Future of local energy institutions and governance | Ofgem](#)

² Flexibility in Great Britain, The Carbon Trust, 2022

Q.3. Under what circumstances would competition, or other procurement models such as open book contracting, have benefits over ex ante incentives as a cost control mechanism?

Unlocking competition

Independence of DSO has the potential to unlock much greater value through increased competition. In addition to DSOs ensuring that reinforcement requirements are tested against non-build solutions such as flexibility, DSOs could also evolve into overseeing the competitive tendering of asset-build solutions that are undertaken currently by DNOs. For example, given that Ofgem's Access Significant Code Review (SCR) means that DNOs will be responsible for a larger proportion of the work associated with connections, UK Power Networks made a commitment in its RIIO-ED2 business plan to open up to competition at least £100 million of work drawn from non-contestable connections work, customer driven diversions and load related reinforcement. The DSO will ensure that the competition for this work is open to all qualifying potential bidders. Increasing competition also increases the pool of resources we can draw in to support us in delivering increased volumes of LCT connections and respond faster to customers' needs.

Ofgem should strongly consider how future network regulation hardwires competitive tendering, focusing on customer driven network reinforcement and diversions, which is where the largest increases are expected. UK Power Networks is already pushing ahead with this. The whole sector should also step up.

The role of incentives and regulation

Incentive based regulation that measures reliability, customer service and connection times – all underpinned by high powered incentives, has formed the recipe for delivering big improvements for the benefit of customers. Furthermore, Ofgem now has over 14 years of cost data from 14 licensees, which puts them in a strong position to benchmark and drive cost efficiencies.

Alongside this competition already has a key role in electricity distribution with ICPs and IDNOs taking the greatest share of new contestable works. The advent of the DSO incentive means there is a much sharper focus on the extent to which licensees are opening up their needs to flexibility markets. In our view this can be complimented with more formal requirements for DSO functions to be ringfenced from the DNO business, aligning to the model we have pursued.

Under Dieter Helm's model all network needs would instead be tendered out under a public body such as the FSO and there would be little to no role for Ofgem. Whilst this would have the perception of increasing competition, it would likely have the opposite effect as it would drive more market consolidation and less regulation. For example, DNOs currently undertake a lot of maintenance and repair work on behalf of ICPs and IDNOs who prefer to compete in other areas. ICPs and IDNOs also benefit from avoiding having to meet the same licence requirements as DNOs, which reduces their overheads.

A major concern with Helm's model is that it would lead to aggressive bidding in tenders and contracts that cannot actually be delivered – so called "winners curse", which has been a feature of PFI contracts and the franchise model in rail. There is also evidence that the direct procurement model used by Ofwat has led to delays in delivery, which need to be factored in.

The use of open book contracting

Regarding open book contracting we are unclear on how exactly this would work and welcome more detail from Ofgem to enable us to provide feedback. Broadly we see parallels with US rate of return regulation and therefore we refer to the pitfalls with this that are highlighted in our response

to Question 5. A key question to ask is how open book contracting would verify the needs of the DNO and encourage more accurate work forecasts?

In RIIO-ED2 we now have several mechanisms, such as volume drivers and PCDs that remove volume risk and focus instead on delivery efficiency (unit costs). There are also directly remunerated services (DRS) mechanisms whereby DNOs receive allowances plus a fixed return undertaking non-traditional and ad hoc activities. We struggle to see how this could be extended to wider areas without undermining or weakening incentives on DNOs to deliver performance improvements at lowest cost. Our view is that wherever possible Ofgem should focus on mimicking competitive markets by assessing comparative cost performance across licensees using established benchmarking tools.

To externally secure direct competitive pressure over the bulk of DNO high volume, but variable and relatively low cost business activity, there would have to be a concession type system or an extension of sub-contracting through open flexible arrangements. It is far from clear that mandating such arrangements would be economically beneficial, and there would have to be core business activities around management and systems that would be excluded. Defining the boundaries would be hard, regulation would be rigid and would be as likely to deliver higher overheads and costs overall as any marginal savings.

To mandate the contracting out of services which competitive businesses think they can perform more efficiently in-house would be a counter-intuitive use of regulation, likely to raise costs rather than reduce them.

In our view it is far better to pursue the current approach of incentive-based regulation to ensure that the networks are motivated to secure the lowest possible cost for works performed, contracting out where this makes financial sense and retaining work in-house where it does not. Any attempt to displace commercial judgement in such cases with inflexible regulation is highly unlikely to improve customer outcomes.

Q.4. What is your view on the options identified for simplification of incentive regulation? What would be the benefits and costs by comparison to the approaches used in RIIO-2?

The introduction of return adjustment mechanisms (RAMs), if calibrated correctly, provide a way to hugely simplify price controls if network company returns are significantly higher than anticipated at the time of setting price controls. We recommend that RAMs are calibrated to allow high performing companies the potential to earn double the base allowed cost of equity by delivering outstanding performance for customers. Rather than regulating for a myriad of inputs, Ofgem could utilise RAMs to provide an upper return expectation that the very best companies can earn if they deliver efficiently and in line with customer expectations enshrined in stretching, but realistic targets. In RIIO-ED2, incentive targets have been ratcheted to impossibly high levels (e.g. UK Power Networks would need to deliver negative Customer Minutes Lost performance to maximise incentive performance for the LPN network) which has skewed the balance towards totex efficiency as a means for high performing businesses to try to perform better than the Ofgem allowed return on equity.

We think this balance needs to be corrected by Ofgem for RIIO-ED3 to put greater emphasis on delivering operational and service improvements related to changing customer needs as they increasingly rely on electricity to enable their transport and heating needs.

Ex-ante regulation and the totex incentive mechanism remain paramount to drive the private sector to deliver greater efficiencies using innovative solutions. Taking a cost-plus approach or ex-post assessment of delivery significantly dilutes the focus of network companies to strain every sinew of efficiency from their operations utilising the latest technologies and solutions

from the market. For example, UK Power Networks has been the frontier network in applying Artificial Intelligence (AI) to get a granular picture of capacity on our low voltage networks without having to implement widescale physical network monitoring. The totex incentive mechanism drives us to find the best way to deliver an outcome (widescale accurate network visibility coverage) at the lowest possible cost because we share the benefit with customers. Given the quantum of future investment needed in the networks, we should be replicating the dynamics of competitive markets to incentivise and reward high performance not moving in the opposite direction.

We strongly believe that RIIO incentives should continue to evolve to reflect the outcomes and changing needs of consumers as they decarbonise their lifestyles. For networks to not be a blocker to decarbonisation, we believe that the customer service incentives should specifically measure low carbon technology connections and enquiries. This measurement should be underpinned by rewards or penalties. Similarly, as electricity will power more of our lives, the reliability incentives should be adapted to measure and reward reductions in momentary interruptions (less than three minutes). Ofgem should also be sharpening the incentive properties for the DSO to find and deliver the lowest cost solutions given the huge customer savings potential from a smarter and flexible energy system. A high performing system and network operator should be able to earn double the baseline return on equity within a Return Adjustment Mechanism threshold as the benefits to consumers should far outweigh the cost of a higher return to the companies.

The FSNR consultation identifies three incentive simplification options, which we review in turn below.

1. Simplified cost incentives for ongoing 'business-as-usual' costs: a targeted return to a simplified cost efficiency incentive for more repeatable activity, or an ex-post review;

The FSNR consultation asks whether a RPI-X model could be used for discreet areas of the business where cost-efficiency is the main imperative and where business-as-usual will more or less continue in the coming years.

When considering such changes we recommend Ofgem focuses on how they deliver better customer outcomes, increase transparency, and whether they create a stable and predictable environment that encourages investment.

Under this lens we see no rationale for applying an RPI-X model to certain types of expenditure. We believe this risks undoing many years of evolution in GB energy network regulation, which is now recognised as world leading. For example, the application of a single totex incentive across expenditure, whereby companies and customers benefit equally from efficiencies has been a key foundation of the RIIO framework, which has delivered significant customer benefit. It is notable that the majority of stakeholders supported the use of totex in 2010 as part of Ofgem's review into regulation at the time. We therefore recommend Ofgem looks at the drivers that led to RIIO and its own review of the RPI-X regime³.

Ofgem should retain a focus on delivering outputs at lowest and therefore refrain from defining separate BaU and non-BaU activities for RIIO-ED3. Splitting cost categories and the cost assessment process would encourage companies to optioneer between cost activities, thereby creating a misalignment between the interests of customers and shareholders.

³ [RPI-X@20 review | Ofgem](#)

The reality is that there is no clean or universal way that costs can be allocated as BaU or non-BaU, and neither could such classifications be fixed in time. Attempting to do this would reduce work synergies, disincentivise innovation, and increase regulatory costs without a clear benefits case. We expect Net Zero and the associated drives towards digitalisation and flexibility to be transformative of all parts of our business in the coming years. Asset management and reliability, for example, needs to evolve to counter the risks associated with climate change and extreme weather, we also need to decarbonise our own activities and address electrical losses, for example.

To highlight the issues we have posed the following questions:

- how would costs be allocated if we uprate an asset's size to future-proof demand but the primary driver was asset health?
- how would we choose between market based flexibility and network reinforcement in a way that avoids any bias?
- how would we classify expenditure that is intended to improve quality of supply?

To summarise, rather than simplifying regulation this change would create more complexity and almost certainly different interpretations between what work is defined as. Furthermore, just because an activity is repeatable it does not mean the cost of it should be expected to come down. This has been demonstrated recently with the supply chain issues our industry has faced and rising energy costs. It is also unclear how regional factors would be applied under this framework.

2. Simplified output incentives if digitalisation allows more frequent and accurate monitoring of network company performance

We agree with Ofgem that making better use of energy system data and digital technologies has the potential to deliver a more efficiently planned, maintained and operated energy system. To turn this vision into reality, there needs to be specific focus on:

- How digital technologies can improve network capacity visibility. Network companies must be able to evidence that they are prepared to efficiently facilitate the Net Zero pathway set by the FSO/RSPs. Ofgem should then set network utilisation targets e.g. at 90% of an asset's rating, that would incentivise companies to release network capacity at the right time and at the right locations, when there is sufficient confidence of need. Visibility of the network is crucial to making this happen. UK Power Networks is already well advanced in developing machine learning models to predict asset utilisation.
- Enabling network companies to utilise half hourly smart meter data at MPAN level. To efficiently plan the network, identify where potential LCT clusters are forming and delivering capacity in time, the use of half hourly data from smart meters at MPAN level is crucial. It would enable network companies to have a high-definition view of what is happening on our low voltage networks to ensure we are not a barrier to decarbonisation. Half hourly load patterns can provide an invaluable signature for the types of low carbon technologies being connected to the network. Currently, network companies are restricted to only seeing aggregated half hourly data at substation level only each month. In the same way that energy suppliers have access to smart meter data to bill accurately, we believe that network companies have a similar legitimate business for such data to fulfil our statutory obligations to plan the network efficiently and ensure sufficient capacity to support customers transitioning to EVs, solar panels and heat pumps.

3. Simplified assessment of costs for 'one-off' investment projects through a combination of lighter-touch approaches to assessment and incentives

As highlighted in our response to Question 2 we see value in creating a streamlined assessment process for enabling well justified strategic investment over £20m to be facilitated through PCDs. This would define a bespoke work programme that focuses on unit cost efficiency of the outputs. However we believe such bespoke PCDs will account for a tiny fraction of overall expenditure in future price controls. For example we were the only DNO to include this type of investment in RIIO-ED2 planning, which accounted for c.£70m.

We recommend that the rules around bespoke strategic investments are robust as to avoid creating different cost assessment approaches and artificial boundaries between activities. Otherwise this could dilute the benefits of cost benchmarking. We would also caution against higher value strategic projects being subject to a lighter touch review and would place more emphasis on streamlining the process and involving RSP validation of needs.

Q.5. What are the network activities where there would be benefits for a move to an ex-post monitoring regime, and what would be the associated costs?

We see there being a very limited role for Ofgem's third archetype described as freedom and accountability in electricity distribution, which equates to rate of return regulation and an emphasis on ex-post cost assessment. In our view this would undermine over thirty years of GB regulation by representing a seismic shift to a model that is proven to be poor at driving innovation, performance improvements and cost efficiency. When it comes to reforming arrangements for delivering future needs we do not believe it is possible to combine, for example, archetypes two and three in any material way as they are generally incompatible. For example, how would a key mechanism such as the totex sharing factor work alongside ex-post mechanisms?

We recognise that there are some exceptions to the rule such as the creation of use it or lose it expenditure pots, which have helped encourage investments in new and important areas such as cyber security. However, we cannot see how this could be applied more widely at electricity distribution in a meaningful way. Any attempt to do so would result in significant disruption and cost, and without the clarity of what benefits could be unlocked based on using a precedent.

We encourage Ofgem to compare the RIIO framework with other regulatory frameworks across the world and find an alternative ex-post regime that has delivered the scale of improvements that we have seen under the GB framework.

Furthermore, movement to an ex-post regime would need careful consideration to avoid ex-post judgements taken with the benefit of hindsight. Doing so could risk introducing even more uncertainty – negatively impacting investment and possibly increased investor risks that would be reflected in a higher cost of capital as we observe in the US.

Any system of assessment must be transparent in order to motivate performance. Businesses must know in advance what performance is expected otherwise they will not be able to achieve the desired standard. Companies need to know what rewards they can expect if management performs optimally.

GB distribution networks will need an inflow of private capital investment in the coming decades. Investors respond best to incentives designed and set at the start and evaluated fairly, where possible on the basis of objective quantifiable data, rather than an ex-post subjective assessment. Even if a framework for ex-post assessment is set in sufficient detail in advance, we are not convinced that this will lead to a positive change.

Q.6. What are the benefits and costs of this approach for Electricity Transmission by comparison to an evolution of the approach in RIIO-2, and what are the implementation barriers?

We have no comments to this question.

Q.7. What is the potential for Electricity Distribution planning and commissioning to move to an alternative model by the end of RIIO-2, and what might be the benefits and costs of doing so?

We support an evolution of the RIIO model and do not see a strong case for moving to a different regulatory model at the end of RIIO-ED2. Please refer to our response to Question 5 for further detail.

Periodic price reviews still provide the best balance to allow changes in the macro-economic environment and changes in government policy to be explicitly recognised in totex allowances, without diluting management incentives to drive performance improvements in efficiency, service, and reliability. Even with significant growth expected in RIIO-ED2, less than 15% of DNOs' totex allowances are linked to load related expenditure⁴. The vast majority of totex expenditure can be benchmarked with frontier efficiency targets set based on actual revealed performance. We understand Ofgem's thinking that there may be exogenous changes happening in-between periods necessitating additional network investment, however we think a combination of strategic planning supported by RSPs and five-year price controls significantly reduces this risk for electricity distribution.

The incentives to produce high quality business plans (i.e. business plan reward and sharing factors) must be sharpened considerably to ensure network companies are ambitious and efficient. In RIIO-ED2, UK Power Networks' business plan was regarded as one of the best with ambitious commitments that enabled Ofgem to set stretching targets for all DNOs benefiting all GB consumers. However, the distinction in sharing factors between the best and worst performing business plans was less than 1 percent. Similarly, the level of business plan reward from submitting an efficient plan was dwarfed by those companies putting in much higher totex increases and benefitting from the sharing factor on any outperformance. Ofgem needs to review how the business plan reward, sharing factor and level of allowed totex from benchmarking fit together into a more coherent package focusing companies to deliver in the interest of consumers. This should be to deliver efficient investment when it is needed, where it is needed and at the level it is needed rather than mass-scale anticipatory investment which is wasteful and inefficient.

Why we should continue to use ex-ante incentive regulation in electricity distribution

There is strong evidence to support the view that ex-ante incentive regulation has led to significant benefits for customers. This is shown by:

- Customer satisfaction on the service provided by DNOs is now averaging over 9/10, which is significantly up since the creation of an output incentive measuring it⁵;

⁴ Data sourced from Ofgem's published PCFM, which contains DNOs' allowances for RIIO-ED2

⁵ RIIO-1 Electricity Distribution Annual Report 2021/22, Ofgem, 2023

- Likewise since the formalisation of a complaints metric in 2012 DNOs have year on year improved scores by improving their complaint management processes, with over 85% of complaints being dealt with after one day⁶
- Over the last twenty years electricity distribution network reliability has vastly improved, with customer interruptions reducing by 55% and their duration reducing by 61%⁷; and
- At the same time electricity distribution has connected over 26GW of distributed generation, over 1m EVs and over 1m Solar PV panels, which demonstrates DNOs ability to manage rapid change⁸.

Underpinning this progress is the shift from input-based regulation, which focused on capital expenditure, towards output-based regulation. This has helped re-focus companies' attention on using innovation and the full suite of options to deliver outcomes that are important for customers at the lowest cost.

We believe that the focus should not be on whether ex ante incentive based regulation is the right model or not, but rather on how can it be improved, as well as recognition of the wider challenges that need to be addressed. For electricity distribution we summarise the key areas of improvement as being:

1. A shift back towards driving companies to focus on earning returns through meeting stretching but achievable output incentive targets that links to customers' priorities;
2. A need for stronger DSO and whole system incentives to ensure that any needs are opened to competition;
3. Evolving connection queue arrangements to better deal with distributed generation applications;
4. A stronger focus on organisational resilience to better prepare networks for when customers most need support; and
5. Independent validation of networks needs and a common energy scenario that acts as a single source of truth between energy sectors.

The first area aims to address the issue that DNOs face today whereby to outperform they must focus on achieving cost efficiencies, as output incentives have either been weakened or the targets put in place are not achievable. The second area listed above is starting to be addressed by the new DSO incentive in RIIO-ED2 but we think there is scope to strengthen this and to consider how whole system decisions can be better incentivised. We are also making progress as an industry on addressing the third issue, which sits outside of price controls.

On the fourth issue we believe that organisational resilience should be better defined and more formalised as part of the price control process. Too often, we hear industry commentators simplify resilience to network investment and asset standards. We believe this view is too narrow. UK Power Networks has adopted the British Standard definition of organisational resilience which focuses on the "capability of an organisation to be prepared for disruption and to adapt and thrive in a changing environment." Adopting such a standard and then seeking independent assessment of our capabilities (i.e. by the Cabinet Office Emergency Planning College), has enabled our organisation to dramatically improve our service to customers when they most need our support such as in severe weather and cyber events. We are the only DNO to have undertaken such a detailed maturity review and submitted itself for independent external assessment like this. The experiences of Storms Arwen, Dudley, Eunice and Franklin reinforce the need for the whole sector

⁶ Ibid

⁷ Ibid

⁸ Based on National Grid ESO data published in FES 2022

to increase overall organisational resilience capabilities. Price control regulation should use the British Standard definition of resilience as the minimum standard, mandate that companies undertake regular external assessment and to publish these results to drive competition amongst companies to continuously improve.

We are aware that Ofgem are making progress on the fifth issue and the creation of the FSO and RSPs will be key to this. Our main concern here is around whether these developments can align to the timetable for the next round of price controls. For example, will it be feasible to consult and establish a common energy scenario ahead of when some companies are due to publish their business plans next year.

Q.8. What is your view on the most effective approach to regulation of Gas Distribution and Transmission beyond RIIO-2? What would be the benefits and costs of moving to a simpler approach to regulation of the ongoing costs of operating and maintaining the network?

We have no comments to this question.

Q.9. Should there be a shorter-term price control in gas distribution and/or gas transmission, and how could this work in practice?

At a minimum we believe there should be alignment of the electricity transmission and distribution price control regimes to encourage whole system solutions. Given the greater dependencies and interactivity between electricity transmission and distribution systems, aligning price control periods will enable a more effective approach to regional planning by ensuring that capacity is delivered in the lowest possible way for customers. Furthermore, if government policy determines that the decarbonisation of heat should be achieved through heat pumps and heat networks, aligning gas distribution with electricity distribution price controls also makes sense to enable a planned decommissioning of the gas distribution grids together with enhancements required to electricity networks on a co-ordinated regional basis.

Q.10. Would there need to be any changes to maintain a stable and consistent financial framework if we were to make greater use of different regulatory archetypes, and if so, what would those changes need to be?

It is generally recognised that the investment in electricity distribution will need to increase over the levels of investment that have been allowed for RIIO-ED2. It is therefore vital that the financial framework for future price control periods produces a cost of capital that is sufficient to attract the necessary capital, both equity and debt, to deliver this investment.

To understand whether any changes are required to the financial framework this first step is to understand what risks are being placed on DNOs by each of the archetypes. As this stage of the FSNR project this is currently not clear. For example, under the plan and deliver archetype the FSO will determine the investment projects that will be undertaken on the network and procure the delivery of those projects. However, the responsibility for maintaining quality of supply will still rest with the DNO. Currently, it is unclear how the DNO mitigates both the risk of the wrong investments being identified and the non or sub standard delivery of those investments which may impact on its obligation to maintain supply quality. We appreciate that Ofgem are at an early stage of the FSNR project but believe that a clear understanding of the rights and obligations that will be placed on DNOs under each of the archetypes is essential to understand the risks that are being placed on them.

Ofgem has posed the question in its finance working group on whether different archetypes should have a different cost of capital. From an investor perspective the use of different costs of capital for different work activities is likely to add unnecessary complexity and reduce transparency with

respect to the allowed returns. This could result in an increase in risk perception from investors which would increase the cost of capital for the sector. Such an approach would seem counter intuitive given a key focus for the FSNR project was to reduce complexity and hence improve transparency. Furthermore, at a practical level it is unclear to us how Ofgem would establish the asset beta for each archetype given the lack of comparators it has for DNOs currently from a whole Business perspective.

Q.11. Do you have any views on our proposed analytical approach?

In our view sectors are facing very different challenges and there are pitfalls in trying to apply to the same building blocks to sectors for the purpose of simplicity or consistency. In electricity distribution we are seeing a continuation in the connection of LCTs and distributed generation, with a focus on how smart and flexible technologies can support cost efficient delivery. In contrast in electricity transmission there is a focus on delivering major infrastructure projects to connect wind farms and large power stations. Whereas gas networks are experiencing decreases in demand and new connections.

As a result there is a strong case for an evolution of network regulation in electricity distribution with a continued focus on output based regulation. We do not see a case for fundamental change. Yet, the risk with Ofgem's analytical framework is that other sectors issues are conflated to electricity distribution. We are also concerned about Ofgem's FSNR timeline, which is being driven by electricity distribution and gas whose price control review processes are two years ahead of electricity distribution. It is notable that in those two years much has changed externally which has been reflected into RIIO-ED2, including the impacts of the pandemic, the war in Ukraine and the ensuing cost of living crisis.

We recommend that the counterfactual model defined to test new options against is sector specific and recognises key developments in RIIO-ED2 such as the DSO incentive, Access SCR reforms and agile uncertainty mechanisms. To do this properly will require collecting sufficient data and realistically about two years' worth. Ofgem's planning must also consider the statutory process for creating new organisations and the constraints this will create. For example we struggle to see a scenario where the FSO is fully operational and able to meaningfully engage in the RIIO-ED3 planning cycle.

In figure 1 we have summarised the key characteristics any regulatory framework should aim to have alongside an assessment of how developed RIIO-ED2 arrangements are in fulfilling these.

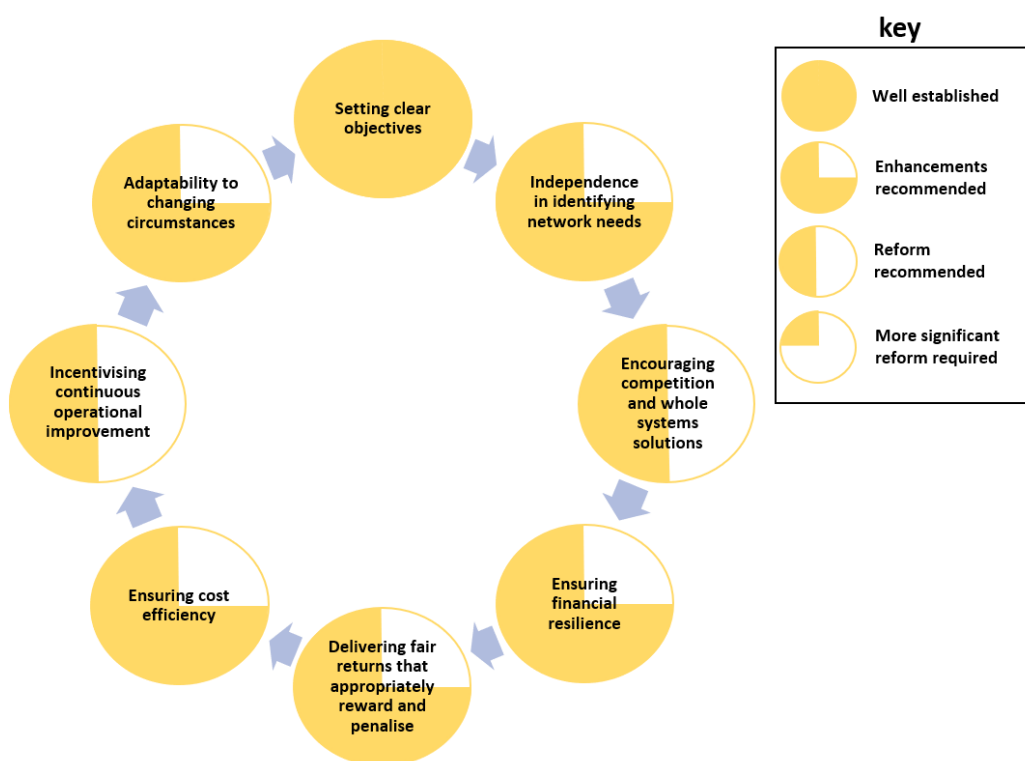


Figure 1: The key characteristics of good regulation

As a final comment we would welcome further engagement on how Ofgem will undertake an impact assessment as part of its proposals as we are keen to ensure that this helps provide a robust justification of Ofgem's final decision.