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RIIO-3 Team, Network Price Controls
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Dear Steve and Akshay,

RIIO-3 Sector Specific Methodology Consultation (the 'SSMC')[1]

Great Britain's energy system is in transition, shifting away from fossil fuels to clean energy in support of net zero, greater energy security and resilience to increasing and varied challenges. We are not alone in this pursuit. Governments in many countries have set ambitious net zero targets, leading to significant competition for supply chain capacity.

A successful transition will only happen with the most radical transformation of the grid seen since the 1950s. We must build the grid of the future. This requires expanding our network at an unprecedented rate alongside upgrading and re-wiring our existing network to create the capacity-rich super-grid we need. We will need to do this at the same time as maintaining today's standards of safety, reliability and resilience for consumers. The scale of what we collectively need to deliver is hugely ambitious and of critical importance. It will ensure that consumers are protected by unlocking the benefits and value of the energy transition, in terms of lower bills, more secure supplies and decarbonisation, by connecting more renewables and reducing constraint costs.

To enable this radical transformation and our management of the challenging macro-environment, the approaches taken by the network companies and the regulatory framework need to change.

The introduction of the Accelerated Strategic Transmission Investment framework is a positive example of Ofgem developing the regulatory framework to accelerate delivery of net zero enabling infrastructure. The principles underpinning ASTI need now to be reflected across the entire RIIO framework. The alternative, to roll forward an ET2 approach to the design of the framework, would risk the energy transition and limit our ability to unlock the benefits for consumers. This cover letter identifies the key changes required, with full detail on the RIIO-ET3 framework in our Q&A response.

To deliver their ambitious plans, electricity transmission owners (TOs) will need to transform themselves before and during RIIO-3 in terms of their size and capabilities. We will make unprecedented levels of investment, recruit and train a new workforce, adopt new ways of working, test and roll-out new technologies and continually seek to innovate further. We will need to do this whilst managing the inherent uncertainty in the demands that will be placed on our network and the wider macro-environment in which we operate.

Working with the National Energy System Operator (NESO) we will also need to manage system access – a scarce resource subject to change in response to external events – that will shape our network investments and how they are executed. Our investment plan will be based on the principle of *'do it once, do it right'*, optimising the use of the outages we have whilst maintaining reliability as we expand the network. We will look at all asset health, connection, and capacity needs for a certain site or circuit together, instead of planning work on them individually and then combining them into a work plan. This way, we can make the best use of the outage and resources we have.

We have already started on this transition. We are changing how we work to drive forward the Accelerated Strategic Transmission Investment (ASTI) projects and applying the lessons for our whole RIIO-3 business plan, including adopting new supply chain strategies which involve us accepting more risk. The design and

[1] This response is from National Grid plc, covering our electricity transmission (NGET) and electricity distribution (NGED) businesses, though we note that the regulatory framework applicable to NGED will be subject to separate consultation, and RIIO-3 should not be seen as setting binding precedent for RIIO-ED3, given important sector differences. It does not cover National Grid Electricity System Operator (ESO).

administration of the regulatory framework will be a key enabler of this transition and we therefore welcome the pragmatic and open approach Ofgem has taken in the SSMC and associated working group sessions.

Although the SSMC recognises the scale of the challenges faced in RIIO-ET3 and beyond, in our view there are areas where Ofgem can and should do more to enable delivery of a successful transition and maximise value for consumers. The key principles are:

- Investment needs assessment must change in RIIO-ET3, and enable projects to progress at pace before final project assessment.
- Costs assessment must reflect new supply chain competition and volatility resulting from the global macro-environment, and move away from historical benchmarking and backward-looking only approaches.
- RIIO-ET3 must maximise the overall value TOs unlock for consumers, which requires changes to the ET2 incentives package.
- The RIIO-ET3 financial framework must reflect the step change in what we are being asked to deliver, the macroeconomic environment, and the need to attract significant volumes of new capital to fund the energy transition, which all impacts the level of risk we hold. This means an allowed cost of equity considerably higher than RIIO-ET2.

The background to these principles and the way they should be reflected in the RIIO-ET3 framework are set out further below.

RIIO-ET3 plans and how they are executed will be fundamentally different to ET2 and that requires a change to how need is assessed and confirmed through the regulatory framework.

During RIIO-ET3, we will be delivering ambitious investment programmes to create additional capacity and connect new customers as is urgently required. We are designing our plan to create a high degree of optionality for how the super-grid of the future can develop, including by investing strategically so the network capacity is available before the need crystallises. This approach was taken when today's super-grid was developed in the 1950s allowing it to stand the test of time. The regulatory framework must facilitate the same approach to planning and investment for RIIO-ET3.

We are developing our investment plan against a backdrop of heightened uncertainty which will still exist at the time we finalise and submit our ET3 plan later this year due to factors including:

- reforms underway to the way in which customer connections are managed;
- new Centralised Strategic Network Plan (CSNP) which will be published by NESO – and the role the TOs will play in this process and in data provision on an enduring basis; and
- the development of a government-endorsed Strategic Spatial Energy Plan (SSEP).

The high option value we are building into our planned investments will help manage these uncertainties and maintain the required pace in investment. For some, this includes getting approval that there is a clear investment need and recognising that the detailed scope of the project will be refined over time. The framework needs to allow early needs case approval, so we can progress and deliver them on time.

Early needs case approval via the NESO (CSNP and potentially more broadly) or Ofgem, as appropriate, is also important because global efforts to decarbonise the world economy are increasing competition for supply chain capacity which we need to be able to manage. This has created an uncertain and rapidly changing supply chain. We are seeing constraints across both our international and domestic suppliers as they seek access to sufficient skills, labour and manufacturing facilities. We are seeing changing appetite from the supply chain to participate in tenders and to make commitments to smaller projects. Instead, suppliers are asking for earlier and larger commitments to secure capacity.

Ofgem has already recognised the need for us to operate at a portfolio scale through the design of the ASTI framework. It is critical that the framework supports longer-term supply chain planning across all of our assets, so we can secure the necessary capacity. The regulatory framework for RIIO-ET3 should allow for such a portfolio scale approach to be taken across other activities where required. This will help support us to secure the supply chain capacity we need in the timeframes required.

It is therefore critical that the framework provides early confirmation of investment need so that we can commence early project development work and make relevant commitments to the supply chain prior to subsequently seeking full project assessment when the detailed plans and final costs are known.

Ask for the framework:
- A clear and efficient process to approve the 'need' for all significant investments that need to be delivered or progressed during the RIIO-ET3 period, whether identified through the CSNP or by the TOs;
- Approval of need (whether as part of the baseline or through an appropriate uncertainty mechanism) should release pre-construction funding and early construction funding, allowing early commitments to the supply chain and the projects to progress at pace before final project assessment. This needs to be applied to strategic projects and portfolios of work across the entire price control and not just the 'Major Projects Regime';
- Regulatory outputs (e.g. PCDs) need to be set at a level which enables TOs to manage known and unknown future changes and make portfolio level commitments to the supply chain;
- Changes to existing volume driver approaches so they do not stifle strategic investment by limiting cost recovery until certain conditions are met (e.g. customer connections where recovery is allowed only when a customer connects and not when capacity is provided); and
- It no longer looks at individual investment drivers in isolation. Given the scale of work required, the need to manage system access and the efficiency benefits of bundling site work together and strategic investment which moves us towards a capacity-rich network, TOs need to look holistically at their investments.
- An appropriate re-opener to support the development of new tooling, processes and capabilities required for the TOs to support the NESO in its whole-system planning role, as those requirements become clearer.

The ET3 framework should recognise that increased global competition for supply chain capacity coupled with geo-political and environmental factors are all driving significant cost volatility.

We are experiencing significant price volatility and long lead times in our supply chain linked to the increased global competition for capacity and ongoing impacts on commodity and shipping costs from macro-events, including Russia's invasion of Ukraine. These factors have led to a major shift away from fixed price contracts and made suppliers unwilling to take on any pricing risk in the contract. Pricing changes from suppliers are also frequently out of line with changes in relevant market indices. We are taking proactive steps to mitigate the impacts of this supply chain volatility and longer lead times through new procurement models and ways of contracting.

We need to be able to make commitments to secure the relevant workforce and equipment to deliver our planned investments on time knowing that we can recover our efficient costs. This is in consumers interests, as the investments we deliver will provide access to cheaper, greener power. Consumers face more risk from investment delays, for example due to increased network capacity constraints and associated costs, than they do from TOs progressing the investments at pace.

The cost assessment approach must recognise the increase in cost volatility when determining efficient costs and improve on the approach used in RIIO-ET2. Moving away from historical benchmarking and backward-looking only approaches is essential in the current environment. Ofgem has already introduced useful mechanisms through the ASTI framework to support us in responding to these supply chain dynamics for example, by enabling a programmatic approach to delivery and mechanisms to deal with fluctuations in costs. A similar approach should be taken across the RIIO-ET3 framework.

Ask for the framework:
- For load and non-load, do not use the flawed RIIO-ET2 'project assessment model' which had to be abandoned for NGET in ET2 due to inconsistencies in the underlying data sets meaning that results could not be benchmarked accurately across the TOs. The same challenges remain for RIIO-ET3;

- Use a late ex-ante model (like ASTI) for: (i) all large projects, with direct costs determined by the market and (ii) projects which are already contracted/in delivery where forecast costs are high confidence. In such an approach, a DIWE (demonstrably inefficient and wasteful expenditure) threshold needs to be applied for assessing costs to avoid exposing networks to excessive risk as commitments will already have been made;
- For projects that are not repeatable and are low volume, recommend expert review of a stratified sample to provide confidence in cost estimation;
- It is neither necessary nor appropriate to split out "indirects" (which risks distorting the supply chain and introducing perverse incentives) nor to phase costs at asset level, therefore BPDT should be much simpler and Ofgem would not need to retain the ET2 approach to an opex escalator which is based on a mathematical error;
- Real Price Effect indices need to better reflect the make-up of electricity transmission projects.

Ofgem's focus should be on ensuring the investments delivered by the TOs during RIIO-3 maximise the overall value for consumers, including through non-totex incentives.

Efficient delivery will always be important, but we welcome Ofgem's recognition that in some cases pace over cost is preferred as it will maximise overall benefits for consumers. The network is already at capacity and consumers are increasingly at risk of not getting the benefits of the cheaper, cleaner energy connecting to the system, with those generators often being paid to not generate. There is more risk faced by consumers from under-investment in the network than the cost of investment itself.

Scrutiny is a key part of the framework and is vital for building legitimacy for our plans and costs, but this should be proportionate and targeted to where consumer value is greatest. Ofgem should therefore assess our business plan against the overall impact it has on the final consumer bill and not just the impact on network costs. Streamlined decision making must be a key part of the framework given the volume of investments which will need approval.

A comprehensive package of non-totex incentives which encourages TOs to continually identify ways to reduce the overall energy cost to consumers and adopt innovative approaches which create value needs to be a core part of the RIIO-ET3 framework.

Ask for the framework: focus the package of incentives on the behaviours and outcomes that will maximise value for consumers and calibrate to be meaningful enough to act upon and provide symmetric opportunity for under/overperformance.

Specific changes needed to the RIIO-ET2 incentive package include:
- Incentivising TOs through the Business Plan Incentive (BPI) on the overall value we realise for consumers. This means focussing more on incentivising complete and deliverable plans that reflect the ambitious nature of what needs to be delivered during ET3, and less on cost ambition;
- amending the approach to setting the Totex Incentive Mechanism rate to reflect changing cost confidence, given the supply chain environment;
- developing alternative customer connection incentive(s) alongside the wider reforms in this space to facilitate the more strategic approach required to manage connections and connect customers in a timely way;
- adding to the existing SO:TO incentive with new whole-system incentives that will support the critical engagement needed between the TOs/DNOs;
- Ofgem should be open to us proposing further incentives as we conclude our development and testing of the RIIO-ET3 investment plan, where we think they would be in consumers' interests.

Attracting the capital to support the scale of investment is a prerequisite for TOs to deliver their ambitious plans. The ET3 framework needs to ensure Britain's energy networks remain an investable proposition.

The RIIO-ET3 price control period will see unprecedented levels of investment by the TOs to achieve the energy transition and unlock consumer benefits. This will require the NGET notional company to attract significant volumes of new capital, both debt and equity. To attract the necessary capital to fund the delivery of the RIIO-ET3 plans, and ensure the consumer benefits are delivered, we will need to be able to deliver appropriate returns to investors.

There has been a step change in the macro environment as we have transitioned from a 'lower for longer' to 'higher for longer' interest rate environment, and the RIIO-ET3 financial framework must recognise this transition. Risk is also increasing for networks, primarily due to the scale of growth, alongside drivers such as supply chain constraints, and returns to investors must properly reflect those risks. Merely repeating the RIIO-2 approach to allowed returns will not result in an investable proposition.

Although we note Ofgem's commitment to follow the recommendations in the UK Regulators Network (UKRN) Guidance on cost of capital, the UKRN's recommendations must be considered in the light of Ofgem's statutory duties, including its new net zero duty. While cross-sector consistency is a desirable aim, when setting the cost of capital, Ofgem must bear in mind the need to attract significant volumes of new capital into Electricity Transmission Owners to fund the energy transition. Ofgem needs to translate their view in the SSMC that: *"appropriate evolution, particularly to deal with macro developments that create new challenges or where updates to best practice can be identified, is likely to underpin regulatory credibility and support the ongoing attractiveness of investment in the sector"* into changes in the financial framework for RIIO-ET3.

Ask for the framework: consider all relevant information including the current macroeconomic environment, increased risk landscape and the need to attract investment to inform:

- a WACC sufficient to attract investment – Ofgem should review all parameters in light of the new market conditions, and not be constrained by the RIIO-2 methodologies where there is a clear case for change. Additional cross checks should be considered, including 'real world' costs of equity financing, and those that focus on the returns available to lower risk debt. National Grid considers that an allowed cost of equity considerably higher than RIIO-2 is required;
- development of a sufficiently robust financeability and investability assessment – the latter investability 'test' should include qualitative and quantitative metrics, be a key market cross check to ensure returns are sufficient to attract the capital required, and inform the decisions Ofgem make as part of the final package; and
- selection of the most appropriate levers to ensure cash is sufficient to support the required investment, and to alleviate financeability concerns inherent in periods of heightened capital outlay.

Our detailed response to the SSMC is primarily focussed on our electricity transmission business, NGET, as the consultation covers the methodology for the RIIO-ET3 price control commencing on 1 April 2026. Our electricity distribution business, NGED, is naturally focussed on its own customer and stakeholder needs in the distribution sector. Whilst NGED recognises the importance of looking at the industry as a whole system to bring the greatest benefits for consumers, NGED is currently engaged in significant policy change during the RIIO-ED2 period including wide-ranging developments in connections reform, Distribution System Operator and the introduction of the Regional Energy Strategic Planners. As such, it is important that decisions taken at this stage of the RIIO-ET3 and GD3 price control setting processes are not regarded as setting binding precedents for RIIO-ED3.

We will all need to engage with stakeholders on the particular policy needs for electricity distribution and the associated price control framework nearer to that time.

We set out our views on Ofgem's proposals in the attached document, taking into account the points made in this letter and have included relevant evidence to support our positions. We welcome the continued engagement from Ofgem during the development of the RIIO-ET3 framework.

Yours sincerely,

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