

RIO-3 Sector Specific Methodology Consultation

Cadent Response to Ofgem Overview Document

March 2024



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Future of Gas

Key Message:

In addition to enhanced baseline funding to enable net zero planning work and to support our customers and stakeholders through the transition, we believe a modified and more agile approach to net zero funding will be required. Vital and urgent work will be identified by Government, Ofgem and the NESO, which might be delayed if progressed through a conventional re-opener. More flexible funding will be required to allow resources to be planned and committed early and the work completed at pace.

We do not support the proposed removal of funding for further hydrogen evidence gathering. The continued provision of a flexible funding route is essential to ensure known critical work can continue at pace, it is not impacted by a delayed heat policy decision and can continue without a hiatus between RIIO-2 and RIIO-3.

We believe further work to consider repurposing and decommissioning considerations can be covered by uncertainty mechanisms as work is identified during RIIO-3.

In the shorter term, and potentially ahead of RIIO-3, we believe an industry wide discussion is required to understand and identify customer disconnection costs and consider how they should be treated. This may require novel funding solutions to support and protect remaining gas consumers, and to ensure costs are borne by the appropriate party.

OVQ1. Do you agree with our proposal for how RIIO-3 should interact with the Hydrogen Transport Business Model?

We broadly agree with the approach and assumption that the Hydrogen Transport Business model will be in place for the start of RIIO-3 and have been working closely with Ofgem and DESNZ for some time to ensure critical hydrogen transport projects can progress. We are particularly proud of our HyNet project which is likely to be the first large scale regional multi-user hydrogen transport and storage system commissioned in the UK. We look forward to the first allocation round expected later this year, as well as clarity on development expenditure funding from Government, anticipated in Q2 2024. Should the approach set out by Government not include development funding, then we note the RIIO-3 framework should be designed to accommodate a continuation of the approach in RIIO-2 (i.e. an ability to utilise the Net Zero Use it or Lose it Funds, Net Zero And Small Projects and Net Zero reopeners to progress these critical hydrogen projects.

OVQ2. Are there any additional activities relating to the development of hydrogen transport infrastructure, or repurposing of natural gas assets, that you think should be funded through RIIO-3, and if so, why do you think this is justified?

Whilst we await the views from Government on funding for development expenditure for hydrogen transport projects, we believe there is a related funding issue that should be considered within RIIO-3. The vast majority of future users of a hydrogen transport system in our Licenced area are currently connected to Cadent's methane system. They are our customers, and we have a duty to support them as net zero conversion plans and options are developed. We have used the Net Zero and Reopener Development fund for the initial work to support industrial and business customers, but this work will continue beyond 2026. Whether it is for hydrogen repurposing or for decommissioning, we believe the requirement to support our customers through the transition is a long-term multi-decade role and

should therefore be funded within our RIIO-3 baseline allowance. This would include customer and stakeholder facing teams, as well as the technical resources providing the necessary plans and supporting information. In addition, we would require funding for the resources and activities required to interface with the NESO (in both its national and regional strategic planning capacities). this latter activity perhaps could take the form of a pass through non-controllable cost from networks to the NESO, in a similar way to our interfaces with Xoserve and our proposals for funding the Joint Office of Gas Transporter costs. These activities are all about managing stakeholder interfaces and planning with respect to the existing network hence RIIO-3 is the right place to fund.

It will also be important to keep flexibility in the framework to respond to emerging government policy around green gas. DESNZ recently published a call for evidence Ahead of setting out a policy position on the 'Future Policy Framework for Biomethane Production'. As an industry we should look to ensure there is flexibility in the framework to allow us to respond to this policy.

OVQ3. Do you agree with the proposal that network costs relating to hydrogen blending at both distribution and transmission level should be included in RIIO-3 net zero related UMs? If so, which mechanism do you think is most appropriate for these costs and why?

We agree that an Uncertainty Mechanism is the right approach for funding costs associated with hydrogen blending. Cadent is planning to utilise the Heat Policy Re-opener in March 2024 to seek funding to enable a change to the distributed entry connection charging arrangements to support entry reinforcements and increased levels of distributed gas. If the associated change to the connection charging methodology is approved and an enabling funding mechanism implemented, then this may also prove to be the preferred method for funding for blending activities. This will require us to ensure the heat policy reopener enables this which we believe it does. In many ways, hydrogen blending is simply another form of entry gas, that can be treated in the same way as biomethane.

If the re-opener and charging change progress ahead of RIIO-3 then it will be necessary to consider whether a different approach is required for RIIO-3 or whether the re-opener initiated RIIO-2 mechanism can be extended. If it is extended, then funding for blending could be included. If the entry charging change is not approved at all, or if it cannot be rolled over into RIIO-3, then an alternative Uncertainty Mechanism will be required to support hydrogen blending. This could be accommodated within the scope of the Net Zero and Reopener Development Fund, which is designed to support such small net zero projects, however it is likely to need some adjustment to ensure it can provide both capital and operating expenditure funding through RIIO-3.

OVQ4. What are your views on the proposal of using the GD specific Heat Policy re-opener, the RIIO-3 net zero related UMs, or a mixture of both to fund network costs incurred as a result of the government's 2026 decision on hydrogen for heating (where RIIO is deemed to be the most appropriate funding mechanism for these costs)?

We support the need for a mechanism to enable rapid progression following the decisions anticipated in the 2026 Heat Policy. The existing reopener mechanisms would provide a good starting point for this, however, to deliver net zero at pace, we believe a modified and enhanced approach is required. The current re-opener process involves time to prepare a quality submission followed by a period for Ofgem assessment and consultation, before funding is or isn't confirmed. Only then, can any external contracts or other resourcing decisions be taken, with time to mobilise. Even where a project is more

straightforward, the time from start to finish can be 6-12 months. Even for one critical project this creates risk of delayed delivery with such a challenging net zero timetable to meet.

We would welcome a new Uncertainty Mechanism which allows Ofgem, Government and the NESO to make basic Use it or Lose it funding available for a specific task they wish the network to complete. As we get nearer to the Heat Policy decision and then plan for its implementation, there will be vital activities Cadent will need to undertake, and at pace, whether the decision leads to large scale hydrogen repurposing or decommissioning. Examples include producing detailed implementation plans for an area, optimising a decommissioning programme with an electricity network, or impact assessments on classes of customer and stakeholder. This new proposed approach where basic funding is provided would allow the networks to start work immediately, but with the ability to apply for additional funding should the need become apparent. We believe such 'push funding' would remove a significant barrier to progressing towards net zero, whilst also reducing the administrative overhead both for the networks and Ofgem and is consistent with the spirit of the mechanisms Ofgem has put in place to accelerate electricity related investment.

The funding could be based on a simple estimate of the likely costs involved. Where work became necessary, the triggering party makes an informed decision on the resource requirements, and this sets the level of the base funding. Networks could use a re-opener type mechanism if additional funds are required, with any underspent projects either resulting in the remaining funds being dissolved, or they could be retained to provide a buffer for any future projects that may overspend, and potentially avoiding a need for an additional re-opener.

This could be implemented with a new Licence Condition where values can be directed by Ofgem, in accordance with a published Guidance Document.

OVQ5. What are your views on our proposal to not enable funding for further evidence relating to repurposing the existing network for hydrogen heating ahead of government's decision on hydrogen heating in 2026?

Given the uncertainty in this area, there is a strong possibility that further work will be required to build evidence at the start of the RIIO-3 period. This would also need to consider preparatory works for the first Hydrogen Towns or first roll out including more complex buildings and stakeholders. There could also be a requirement for additional consumer, safety and technical evidence and the possibility that the heat policy decision could be delayed beyond 2026 whilst more data is collected. We see hydrogen conversion and the associated technical research as an opportunity to continuously learn. A pause in research now would lead to the decline in expertise in hydrogen as they will be deployed onto different projects.

We therefore do not support the proposed removal of funding for further evidence gathering. The continued provision of a flexible funding route is essential to ensure this work can continue at pace and continue without a hiatus between RIIO-2 and RIIO-3. We consider it is likely that, to meet the challenging Net Zero targets on time will need a multi-layered approach which does not rely solely on electrification. As a result, keeping the option of a clear funding route for evidence gathering under the RIIO regime will provide the necessary flexibility whilst also signalling the importance of this work. This will also help ensure industry and supply chain interest is maintained, which will be critical to delivery at pace.

OVQ6. Should RIIO-3 help to manage future gas network decommissioning costs? If so, do you have views on what these costs could be and what mechanisms should be used, including for anticipatory funding?

In practice we are many years away from physically decommissioning substantive elements of the gas network, as this cannot commence until the new infrastructure and replacement appliances for any alternative for the end user are in place. It is accepted that the large-scale electrification of heat will require an enormous level of new production and an expanded and upgraded network, which must be in place before the demand switches on. Practical sequencing for switchover means any detailed decommissioning plans for the gas network cannot start ahead of the delivery plan for electrification. Electrification itself may drive gas network retention to supply the massive back up and distributed power generation requirements that will need to be met during peak demand conditions.

Whilst very detailed planning work is contingent on other infrastructure plans and enabling policy decisions, there could be projects the GDNs could undertake during RIIO-3 to inform policy and provide higher quality cost assessments. Given the likely need for such work to be needed across all gas networks, funding for this work may sit better within the Net Zero and Re-opener Development fund. This may require amendment to the Governance document to clarify its use for decommissioning planning activities.

In the shorter term, and potentially ahead of RIIO-3, we believe an industry wide discussion is required to understand and identify customer disconnection costs and consider how they should be treated. This may require novel funding solutions to support and protect remaining gas consumers, and to ensure costs are borne by the appropriate party.

Role of Scenarios and Planning Pathways

Key Message:

Scenarios and planning pathways are not as relevant to RIIO-3 for the gas sector. Our planning for RIIO-3 is largely non-load related and underpinned by completing the mains replacement programme and ensuring safety and resilience of the network in line with our legislative obligations. We therefore propose that Ofgem use common planning assumptions instead for the gas sector to cover the minority of elements that are variable and require consistent assumptions to derive a baseline. This also avoids any other unintended consequences of tying plans to specific FES scenarios.

OVQ7. Do you agree with the proposal to use the FES framework for selecting the RIIO-3 scenarios?

We have provided a single answer to questions OVQ7, OVQ9, OVQ10 and OVQ11, as all four questions address common themes.

In summary:

- The bulk of gas network expenditure is non load related; hence the choice of scenario has less consequence for the content of business plans.
- Whilst there are some elements of our plan which are load related (such as the need for capacity upgrades, reinforcement and connections/disconnections), these are of low materiality in the gas distribution sector and are already managed through Price Control Deliverables (PCDs) and Uncertainty Mechanisms (UMs).
- Tying to a specific FES framework scenario is therefore not required for gas network planning - instead we consider gas network business plans would be better served by a set of common planning assumptions which drive consistency across the gas networks.
- Using a separate set of common planning assumptions has additional benefits. It will avoid the need to update our plan when FES 2023 is replaced by FES 2024. It will also minimise the risk of unintended consequences. Requiring the gas networks to base their plan on a particular FES may inadvertently lead stakeholders and investors to attach undue weight to a particular scenario, which might have implications for the cost of capital for the sector.

Below, we briefly set out the drivers of gas network expenditure, explain why the FES framework should not be used for gas networks scenarios, and describe an alternative approach that we consider would be better suited to the needs of the gas industry.

Our response to this question focuses solely on the use of the FES framework for the gas networks - our response to OVQ8 considers the use of the FES framework for electricity transmission.

The drivers of gas network expenditure

The gas networks will need to serve customers for decades to come. Under the 1986 Gas Act (Section 9), we have a duty “to comply, so far as it is economical to do so, with any reasonable request ... to connect to [our] system, and convey gas by means of that system to, any premises.” This legal obligation means that a gas pipe will remain in service until there are no customers connected to the pipe who want to use gas from or inject gas into the pipe.

The bulk of gas network expenditure is non load related. The gas networks must stay safe and resilient for as long as they remain in use. Thus, in common with the other gas distribution businesses, the majority of our expenditure is driven by safety requirements and the need for the network to be

resilient. For example, we have a legal obligation, enforced by the Health and Safety Executive, to complete the Iron Mains Replacement programme which makes up the largest proportion of our costs.

In addition, the majority of our asset health related investment is related to safety and resilience drivers.

Load related investment is thus less of a driver of our expenditure, but we do need to take account of:

- The obligation on us to ensure we have enough capacity to meet the expected 1-in-20-year peak demand (this involves named projects which are managed through PCDs); and
- The need to connect and disconnect customers to our network (this volume uncertainty is currently managed via revenue driver UMs).

Why the FES framework should not be used for gas networks scenarios

The FES should not be used to construct gas networks planning assumptions, for three reasons:

- The choice of FES scenario does not change the level of non-load expenditure needed to keep the network safe and resilient. Non load expenditure will account for the vast majority of the spend on our network in RIIO-GD3. Whilst different FES scenarios are associated with different levels of gas demand, changes in the level of annual gas demand will not alter the need for the gas network in the RIIO-GD3 period and are managed through UMs and PCDs in any case. (For example, a 10% reduction in domestic demand does not equate to a linear 10% reduction in assets required, and we must also continue to serve industrial and commercial load embedded deep within the networks.)
- Although the FES scenarios are a useful guide at a whole energy system level, they do not contain enough detail to translate into direct implications for investment and planning on the gas distribution network - further work and assumptions around peak demand levels and the location of changed customer demand would be required even if they were used.
- Our view of 1-in-20-year peak demand is not driven solely by the FES. We cannot take the risk that our network is unable to cope if there is a possibility that demand could come in higher than projected by a specific FES forecast (for example the “Leading the Way” FES scenario) - neither would our customers or other stakeholders want us to take this risk. However, given its Net Zero duty, it might be problematic for Ofgem to endorse the “Falling Short” FES scenario as it does not meet the Government Net Zero target.

An alternative better approach

Rather than using the FES, we suggest that Ofgem use common planning assumptions for the gas sector. These assumptions should cover the variable factors that require a consistent approach across different businesses. We are working with the other businesses to agree these assumptions.

Critically, these assumptions will need to include the payback period assumed for discretionary investments. In line with our obligations and the need to ensure safe, resilient service which minimises the impact on the environment, we consider the payback for discretionary investments should be 25 years. This would be consistent with the Net Zero target date of 2050 and reflects the fact that the network investment will be serving customers connected to the networks into this timeframe.

In addition, we could determine a common base assumption and then use revenue drivers to adjust for different levels of connection and disconnection activities.

Furthermore, agreeing common planning assumptions, which are not tied to specific FES scenarios, has two practical and important advantages for consumers:

- It will remove the need for the gas networks to modify their business plans late in the business planning process. From recent collaborative industry engagement sessions, it appears that the emerging FES 2024 could be very different from the FES 2023. It will be difficult to anticipate the nature of changes for FES 2024 and the scenarios will be published too late in the year to be properly reflected in gas network business plans.
- It will minimise the risk of sending the wrong message to investors. Requiring the gas networks to base their plan on a particular FES may inadvertently lead stakeholders and investors to attach undue weight to a particular scenario. This might have an unintended consequence on the cost of capital for the sector.

OVQ8. Do you agree with the proposal to use FES Leading the Way as the planning scenario for ET in RIIO-3?

We agree with the intent to focus on a scenario such as Leading the Way which might put the most onerous stretch on the electricity network infrastructure to plan to avoid the risk of the infrastructure being a constraint on delivery should such a scenario outturn. Our expectation would be that this scenario may change significantly in the updates for FES 2024 given practical progress on some of the assumptions implicit within the Leading the Way 2023 scenario. We do support having different planning assumptions for different sectors.

OVQ9. Do you agree with the proposal to use two FES planning pathways for the gas networks, i.e. Leading the Way and Falling Short as the additional common conservative scenario?

See our response to OVQ7.

OVQ10. Is Falling Short the most appropriate common conservative planning scenario to be used for the gas networks? Or is a common gas network developed scenario more appropriate?

See our response to OVQ7.

OVQ11. Is it feasible for all network companies to initially plan against FES 2023 before updating business plans in line with FES 2024, as proposed?

See our response to OVQ7.

Outputs and Incentives

Key Messages on the toolkit:

The existing RIIO output and incentive toolkit, including Licence Obligations, Price Control Deliverables and Output Delivery Incentives, remains fit for purpose for RIIO-GD3. These tools are most effective when they are well targeted in alignment with desired network behaviours and customer outcomes, and are well designed to deliver against these requirements.

We believe the system of incentive regulation works, and excellent network performance across RIIO-GD1 and RIIO-GD2 to date evidences that the financial incentive toolkit within the RIIO framework works in driving the desired company behaviours and benefits for customers.

Whilst we welcome the overall message of support for incentive regulation within the SSMC, this is not currently aligned to what is being proposed for RIIO-GD3. When assessing the individual areas of output incentivisation in the SSMC there is a plausible low case assessment for RIIO-GD3 of a narrowed output incentive range of around -1.0% RoRE to <+0.1% RoRE at a Cadent company level.

All of the existing RIIO-GD2 areas of output incentivisation remain relevant for RIIO-GD3, subject to the evolution of the Customer Satisfaction and Collaborative Streetworks incentives. For RIIO-GD3 network behavioural change, leadership and coordination is needed to drive the whole system transition to net zero. This suggests the need for the incentive range to be rebalanced with more positive incentives available for networks that can reduce their environmental impact now and play a leading role in enabling the energy system transformation.

As such, our current assessment suggests an output incentive range in the region of $\pm 1\%$ RoRE would support the delivery of the desired customer outcomes for this period. The RAM thresholds can be reviewed and set at levels which provide the confidence to set financial output delivery incentives that customers will value, by ensuring that customers and networks are insulated from the risks of miscalibration.

We support the continued targeted use of reputational incentives in RIIO-GD3. We agree that reputational incentives can influence companies' behaviour in a positive way, albeit not as strongly as with a financial incentive.

We support the targeted use of PCDs in RIIO-GD3 and Ofgem's proposal to introduce a materiality threshold. However, we think that further consideration is needed in developing the principles that would define whether a mechanistic PCD or volume driver is used as they have very similar characteristics but PCDs introduce additional regulatory burden.

We agree with Ofgem's proposal to allow bespoke outputs only in "exceptional circumstances", however we do advocate their continued use as there are strong examples of where they have been successfully applied in RIIO-GD2. These include our Personalised Welfare PCD, which the SSMC consults on integrating into the scope of the VCMA for all GDNs in RIIO-GD3, and the Collaborative Streetworks financial incentive, which the SSMC consults on retaining and potentially extending to all networks for RIIO-GD3.

Whilst we strongly agree that the objective of the RIIO framework should be to deliver great outcomes for customers regardless of where they live, or operate their business, bespoke outputs should not automatically be rolled out to all GDNs. We would propose that the success and relevance of bespoke outputs are monitored during the price control period for subsequent consultation on their rollout to all networks, to achieve consistent service, at the following price control.

OVQ12. Do you agree with our proposed approach on the role, scope and format of PCDs?

We support the continued use of PCDs in RIIO-3. However, the majority of RIIO-2 PCDs have not been delivered yet, which makes it difficult to fully comment on all aspects of their use, most notably the close out process for evaluative PCDs.

We support Ofgem's proposal to introduce a materiality threshold for the use of PCDs. We note that in RIIO-ED2 the threshold used was £15m; a threshold in this region for RIIO-GD3 would be appropriate. We would welcome further working group discussion on if a fixed £m threshold should apply to all networks, or if the threshold should be expressed as a percentage of base revenue / Totex. Likewise, consideration should also be given to if the same thresholds should apply to both programmes of work and individual projects.

We agree that companies should highlight the potential consequences of delay and non-delivery of PCDs as part of the needs case in their business plans. However, any ex-post assessment must ensure that network companies are not penalised for a delay in delivery or non-delivery of PCDs where the reasons for this are outside of their control. This should be a key principle for Ofgem's ex-post assessment framework to be applied in both RIIO-2 and RIIO-3.

We support the objective of ensuring increased delivery flexibility in RIIO-3. Setting PCDs on a customer outcome basis will support this. Where a network can demonstrate that efficient overspend relating to a change in scope has delivered additional customer benefits then the ex-post assessment process should be able to increase allowances accordingly.

We are broadly supportive of the criteria set out in the SSMC for setting mechanistic PCDs. However, the criteria listed would equally apply to setting a volume driver (which can have caps applied to limit allowances). As such, the framework should include clear criteria on guidance that differentiates between where a mechanistic PCD or a volume driver should be used. There is greater monitoring, and associated burden, with mechanistic PCDs than volumes drivers, so it may be this need for closer monitoring that is the differentiating criteria.

As an example, in RIIO-GD2 there are PCDs for Tier 1 Mains and Services which in RIIO-GD3 may be more appropriate as volume drivers. The mandatory iron mains replacement programme is nearing completion so there is limited scope for deviation on the mains to be replaced, and GDNs must undertake interventions on the services found whilst undertaking this mains work. The safety regulator, the HSE, will closely monitor the completion of this work, so there is no need for additional delivery monitoring through the RIIO-GD3 framework.

OVQ13. Do you agree with our proposed framework for setting financial incentives? Are there any additional considerations that we should take into account?

We believe the system of incentive regulation works and that further financial output incentives within the RIIO-GD3 framework will deliver better outcomes for customers while the Return Adjustment Mechanism (RAM) can ensure that overall returns will be neither too high nor too low.

Network performance across RIIO-1 and RIIO-2 to date evidences that the financial incentive toolkit within the RIIO framework can, and has, worked in driving the desired company behaviours and benefits for customers.

Companies are delivering excellent performance in a number of areas. We believe that the RIIO-GD2 incentive package, which is weighted more towards penalties (ranging from around -1.0% RoRE to

<+0.5% RoRE at a Cadent company level), is reflective of locking in the good performance that was delivered by networks in previous controls.

All of the existing RIIO-GD2 areas of output incentivisation remain relevant for RIIO-GD3. However, evolution and/or expansion of the Customer Satisfaction and Collaborative Streetworks incentives is needed to ensure even greater customer benefits can be delivered. Please see our responses to GDQ35 and GDQ39 for our thoughts on how this could be achieved.

For RIIO-GD3 network behavioural change, leadership and coordination is needed to drive the whole system transition to net zero. This suggests the need for the incentive range to be rebalanced with more positive incentives available for networks that can:

- Reduce their environmental impact now; and
- Deliver the behavioural change, leadership and coordination that is needed to enable the energy system transformation.

Please see our responses to GDQ2 and OVQ21 for our thoughts on how incentives could be developed to support these objectives.

Whilst we welcome the overall message of support for incentive regulation within the SSMC, this is not currently aligned to what is being proposed for RIIO-GD3. When assessing the individual areas of output incentivisation our high case assessment of the RIIO-GD3 SSMC appears to be broadly in line with RIIO-GD2, however the low case includes removing a number of positive incentives and further skews the range to the downside (ranging from around -1.0% RoRE to <+0.1% RoRE at a Cadent company level). See the table below for our assessment of the SSMC individual output incentives and overall package.

Financial Incentive	RIIO-GD2	RIIO-GD3		
		SSMC – Low Case Assessment	SSMC – High Case Assessment	Cadent SSMC response view
Unplanned Interruptions	-0.25%	-0.25%	-0.25%	-0.25%
		No options to change value presented in SSMC		
Complaints	-0.25%	-0.25%	-0.25%	-0.25%
		No options to change value presented in SSMC		
Customer Satisfaction	±0.25%	-0.25%	±0.25%	±0.25%
		Para 4.51: Implement penalty only	Para 4.49: maintain RIIO-GD2 value range	Retain incentive with revisions to drive further improvements
Shrinkage	±0.06%	-0.06%	±0.06%	±0.25%
		Option 3: Implement penalty only	Option 1: Retain current incentive	Significant customer benefit in incentivising the pace of transition to observed measurement
Collaborative Streetworks	+0.07%	+0.07%	+0.12%	+0.12%
		Para 4.95: Retain for Greater London area	Para 4.98: Consider expanding to all GDNs	Support the expansion to all GDNs
Net Zero Collaboration	n/a	n/a	n/a	+0.25%
				High value area aligned to Ofgem priority
GSOP	-0.12%	-0.12%	-0.12%	-0.12%
	Our current performance			
Value range	-0.93% to +0.38%	-0.93 to +0.07%	-0.93% to 0.43%	-1.12% to +0.87%

Figure OVQ13.1: Our company-level RoRE value of financial output incentives

We broadly agree with the framework for setting output incentives presented in the SSMC. However, there is a key principle missing from this framework – that it is the best outcome for customers if all networks positively respond to well-designed incentives (i.e. work to deliver the behaviours and outcomes that means they achieve the rewards and avoid the penalties). This supports the objective that customers should receive good service no matter where they live or operate their business (no post code lottery).

We therefore support the continued use of static targets when developing financial incentives as they provide certainty to companies, enabling long-term planning, and align to the approach of the Totex Incentive Mechanism thus ensuring consistency across incentives within the framework.

We would not support the introduction of relative, zero sum, fixed pot or sectoral annual resets (dynamic targets) for incentives. This would introduce unnecessary complexity and drive undesired company behaviours where networks would not collaborate or share best practice as they need others to lose to ensure they win. They do not support the over-arching objective of encouraging better service for all customers (avoiding post code lottery). They could, in fact, actually reward companies for providing a worsening service, as long as the deterioration was less than seen from others.

The use of relative, zero sum, fixed pot or sectoral annual resets (dynamic targets) also creates a disconnect between the incentives on Totex and those on outputs, with those on Totex being predictable and those on outputs not. In this scenario it would be difficult for a company to decide whether to incur costs to achieve a better output. This approach would be both unpredictable and inconsistent between the treatment of Totex and outputs and therefore bad for incentives.

These negative outcomes associated with the use of relative, zero sum, fixed pot or sectoral annual resets (dynamic targets) for incentives are amplified in a sector with only three ownership groups and one company making up half of the sector.

Finally, we agree with Ofgem that the incentive package should be designed in the round. Ofgem should look at the overall range of incentivisation over the price control and look to deliver a framework that does not unduly create downside risk to investors and does contain some upside potential for positive performance to ensure that investment is encouraged in the sector and cost of capital delivered efficiently. We believe the RAM thresholds should be considered and set at levels which manage those risks but enable confidence to set financial output delivery incentives that customers will value, by ensuring that customers and networks are insulated from the risks of miscalibration.

OVQ14. Do you agree with our approach to setting reputational incentives? Are there any additional considerations that we should take into account?

We support the continued targeted use of reputational incentives in RIIO-GD3. We agree that reputational incentives can influence companies' behaviour in a positive way, albeit not as strongly as with a financial incentive.

We broadly agree with the framework presented in paragraph 6.72 of the SSMC GD annex to set reputational incentives, however we would note the following points:

- The most significant factor is whether there is a clear stakeholder interest. However, we would interpret this as a requirement that stakeholders are proactively interested in the issue, and that the issue is reported in a way that meets this interest. It should not be sufficient to identify a theoretical interest that stakeholders should have.

- If another lead organisation, for example the HSE on safety, is already monitoring company performance then a reputational incentive, within the RIIO-GD3 framework, should only be used in exceptional cases where there are additional drivers that require measuring.
- Ofgem should consider the burden placed on companies by the introduction of a reputational incentive and any duplication of reporting.

OVQ15. Do you agree with our proposals for bespoke outputs? Are there any additional considerations that we should take into account?

We agree with Ofgem's proposal to allow bespoke outputs only in "exceptional circumstances", in an effort to simplify the price control process. However, bespoke outputs should remain a valuable element of the RIIO-GD3 framework, as there are examples of where they have been successfully applied in RIIO-GD2 and have delivered significant customer benefits.

These examples include our Personalised Welfare PCD, which the SSMC consults on integrating into the scope of the VCMA for all GDNs in RIIO-GD3, and the Collaborative Streetworks financial incentive, which the SSMC consults on retaining and potentially extending to all networks for RIIO-GD3.

We note that one concern with bespoke outputs highlighted in the SSMC, and through Ofgem's RIIO-3 working groups, is that they could create inconsistent levels of service across geographical locations. Whilst we strongly agree that the objective of the RIIO framework should be to deliver great outcomes for customers regardless of where they live, or operate their business, bespoke outputs should not automatically be rolled out to all GDNs.

Bespoke outputs will be developed through network-specific customer and stakeholder engagement in conjunction with a company's Independent Customer Challenge Group. Therefore, whilst there could be instances where they are applicable to all networks, the driver for the output may be network or company specific. If proposed bespoke outputs were to be automatically rolled out across all GDNs, other companies are also unlikely to have time to successfully cost, test and implement them. As such, we would propose that the success and relevance of bespoke outputs are monitored during the price control period for subsequent consultation on their rollout to all networks, to achieve consistent service, at the following price control. Alternatively, Ofgem could attach re-opener mechanisms to bespoke outputs to allow other networks to test the drivers for the output with their customers and stakeholders, cost up the implementation of the output and then submit an application to Ofgem for the output to be applied to them.

In advance of RIIO-2, networks employed considerable efforts to develop and propose bespoke outputs, with only around 27% allowed by Ofgem by the Final Determination. To avoid repeating this in RIIO-3, we recommend Ofgem provide clear guidance as to what might constitute "exceptional circumstances".

OVQ16. Do you agree with our proposal to retain the EAPs and AERs in RIIO-3? Please provide reasonings for your position.

The Environmental Action Plan (EAP) has proved to be a useful mechanism for companies to capture their environmental sustainability ambitions and targets, and the Annual Environmental Report (AER) provides a reporting platform to assess how companies are performing against their EAP. We support Ofgem's proposal to retain both mechanisms in RIIO-3.

The environmental sustainability space is a rapidly evolving one, which shifts as social / political expectations change and economic factors (e.g. price of renewable energy) are applied. It is almost impossible to predict how advances in technology, changes to laws or environmental standards will impact the environmental landscape, or indeed, what good will look like in five years' time. As such, an alternative to the EAP, which could involve a series of output delivery incentives, based on fixed targets would be very difficult to implement, as targets set on day one would almost certainly not remain optimal throughout the price control period.

The EAP allows for this uncertainty, whilst also holding companies firmly to account (through the AER) to demonstrate that robust and meaningful improvements are being made on an annual basis. The EAP is considered 'in the round', with Ofgem (and other external stakeholders) assessing the merits of it in terms of its levels of ambition and the benefits it is seeking to achieve. It is incumbent on companies to clearly articulate why its plans are robust, relevant and, importantly, supported by customers and expert stakeholders.

In assessing the quality of EAPs, we believe that Ofgem should consider the level of ambition, innovation and strategic fit with company's core business offering, rather than the number or breadth of actions. In the case of Gas Distribution Networks, EAPs should focus on reducing greenhouse gas emissions, improving the accuracy and transparency of environmental reporting and on inter-industry collaboration to support the UK's energy transition process.

OVQ17. What are your views on the new proposed AER format with Commentary and KPIs?

We agree with proposal to implement a common report structure which would comprise an AER commentary and an AER KPI table as it provides simplicity and should provide better comparison between Gas Networks. We also support the proposal for this to remain an ODI-R.

As stated in response to Question 16, whilst we support the inclusion of ambitions and targets into EAPs, it is important to recognise that the relevance and appropriateness of these targets, in some cases, will change materially over the course of a five-year price control period. Therefore, it is essential to include commentary to supplement the KPIs included in the report. This will ensure that an assessment of delivery against EAPs is completed 'in the round' rather than focusing solely on simple KPIs.

We also believe that KPIs should be outcome based. For example, measuring carbon abatement or biodiversity improvements, rather than purely output based (e.g. rate of Electric Vehicle replacement or number of trees planted). This wider, more considered approach to KPIs will help ensure that companies are assessed against the benefits achieved, encouraging innovation, creativity and continual improvement throughout the price control period.

In supporting the principle of a common report structure, we see this as setting a 'minimum standard' and not restricting companies from providing additional details in their report. We work extensively with customer groups and expert stakeholders who help to inform the level of reporting granularity and transparency that is expected of a company leading in this area. Therefore, we believe it should be acceptable, and even encouraged, that companies provide additional (to minimum requirements) information, case studies, etc., into their AERs. This will also reduce the need for companies to create additional reports, often at significant cost for other, similar purposes.

OVQ18. Do you agree with our minded-to position of retaining the reputational incentive on TOs and GDNs for reducing their BCF?

For a Gas Distribution Network business, such as Cadent, there is no more important measure of environmental performance than its business carbon footprint, especially when including gas shrinkage. Therefore, we fully support a robust measurement of BCF as being a critical part of our EAP. We will focus on driving down leakage (shrinkage) in parallel with our ongoing initiatives to demonstrate hydrogen at scale in both industrial and domestic situations. We'll also continue to support the increase in biomethane injections into the network to further reduce our carbon footprint.

However, we do not necessarily believe that this needs to be separate from the EAP (and AER), which we, and Ofgem are already proposing remains an ODI-R. We anticipate that the majority of Cadent's EAP will be focussed on reducing greenhouse gas emissions, including reducing our carbon footprint. Whilst we will also focus on a series of nature-based solutions / improvements and driving our waste levels down even further, by comparison, these actions will have a far lower impact than the work we do to reduce greenhouse gas emissions.

We therefore recommend that the additional BCF ODI-R is rolled into the proposed ODI related to the EAP and AER, simplifying reporting requirements and incentivising a greater level of focus on greenhouse gas emission reductions within EAPs, which, is by far the most important area of environmental performance improvement for energy networks.

OVQ19. Are there any other suggestions you would like to make regarding reporting standards?

Through extensive engagement with our customers and expert stakeholders, we know that accuracy and transparency in environmental performance reporting is incredibly important. As such, in preparation for RIIO-2, we worked with the Carbon Trust and SBTi (Science Based Targets initiative) to seek external science-based accreditation over our greenhouse gas emission targets. Whilst SBTi are still working on their methodology for oil and gas companies, we have continued to work with the Carbon Trust to seek this level of external recognition.

We have achieved accreditation from the Carbon Trust and are working on a series of recommended actions to improve our reporting standards even further. We accept that Cadent are further along this journey than many other energy network companies, but would recommend that it is good practice for all network businesses to be working towards such a standard, demonstrating annual improvement throughout RIIO-3. We also recommend that this should be a formal action in all company's EAPs. Cadent currently measures its emission reduction against a 1.5, 1.75 and less than 2-degree temperature increase pathway.

One of the key recommendations that the Carbon Trust has made is that we work towards moving from modelled estimation of leakage to observed reporting. The current shrinkage and leakage model has underpinned the delivery of significant environmental benefits by the GDNs. However, the leakage rates utilised in the model are now over 20 years old and the model does not incorporate all GDN assets. There are now new technologies available that provide the opportunity for more frequent and accurate leakage measurement. And the Digital Platform for Leakage Analytics (DPLA), which is being developed through a joint Gas Network SIF project, will be able to process all of this data and significantly improve the accuracy of reporting.

The timelines for this transition to observed measurement of leakage are uncertain and are likely to vary across GDNs. As such, in our response to GDQ1 we set out a proposal that shrinkage reporting in the AER continues to be on a modelled basis using the existing Shrinkage and Leakage model. This modelled reporting in the AER should then be supplemented by additional observed measurement reporting tied to any financial output delivery incentive or use-it-or-lose-it allowance that is introduced.

Whilst this “parallel running” of reporting may add some additional burden for GDNs, it will be required to provide transparency during this transitional period. Then from RIIO-GD4 all leakage reporting can be based on observed measurement.

OVQ20. Do you agree with our minded-to position to withdraw the Environmental Scorecard and incentivise improvements in environmental impacts through the Annual Environmental Report (AER)? Please explain your reasoning.

Whilst this is not of direct consequence to Cadent, as a GDN, we support the recommendation based on the principle of simplification, standardisation and focussing the assessment of environmental performance through the EAP and AER.

OVQ21. Do you consider that there are other areas which require financial incentives which cannot be captured by the AER? Please explain your reasoning.

In our response below we identify two areas where financial incentives, outside of the AER, would support the delivery of critical environmental benefits. These areas relate to accelerating gas leakage reductions and driving better coordination in the Net Zero transition.

The importance of the framework driving leakage reductions

Under all credible energy transition pathways, the gas network will continue to play the role of heating the majority of domestic premises and powering businesses / industry for decades to come. Whilst hydrogen is likely to play a significant role in the future, the gas network will be transporting natural gas for a long time and therefore it is essential that companies are encouraged to minimise the negative environmental impact of this process.

There is no greater positive impact that GDNs can have on reducing the climate impact from our operations than by tackling gas leakage from our network – over 95% of its overall carbon emissions.

The mains replacement programme has delivered, and will continue to deliver, reduced leakage as metallic pipes are replaced with plastic ones. Likewise, the shrinkage and leakage model has underpinned the delivery of significant environmental benefits year-on-year by the GDNs by incentivising a strong focus on pressure management, the spread and saturation of mono ethylene glycol (MEG) and optimising mains replacement activity based on the data available. However, the leakage rates utilised in the model are now over 20 years old, the model does not incorporate all GDN assets, and only supports intervention decisions at a cohort level.

There are now new technologies available that provide the opportunity for more frequent and accurate leak detection and measurement. And the Digital Platform for Leakage Analytics (DPLA), which is being developed through a joint Gas Network SIF project, will be able to leverage the right combination of these new technologies. The DPLA will also be able to process all of this data and enable GDNs to significantly improve the accuracy of reporting as most importantly enable optimised intervention decisions to be made, accelerating leakage reductions efficiently.

As such, the move from modelled to observed leakage reporting must be a priority for RIIO-GD3. In our response to GDQ2 we set out our support for Ofgem’s proposal to introduce a use-it-or-lose-it allowance to enable this transition during RIIO-GD3. We also propose that, given the societal value at stake, consideration should be given to how to incentivise the pace of this transition. Our response to GDQ2 includes options for how the pace of this transition and delivery of accelerated leakage reductions could be incentivised. We also commit to continuing to develop and test these proposals with our Independent Customer Challenge Group and set out a request for further engagement with

Ofgem, other GDNs and wider stakeholders between SSMD and business plan submission to develop these options into something that could be consulted on as part of Draft Determinations.

The importance of the framework driving better coordination on the Net Zero transition for customers

We support the view in paragraph 6.90 of the Overview document of the Sector Specific Methodology consultation, that there is scope for more incentives that encourage network companies to coordinate with each other and common incentives that could be developed to provide better outcomes for consumers. We have been working with our independent Customer Challenge Group on exploring where and how an incentive might be valuable for consumers and set out below the proposal we are developing further.

Why do we believe an incentive in this area would benefit consumers?

The effective transition to Net Zero is the critical area for both existing energy and future consumers. The transition not only impacts the development and evolution of energy infrastructure, which consumers have helped fund over decades, but also impacts their daily lives both in the energy appliances and means by which they heat, consume power and cook in their homes and as the means by which public facilities such as schools and hospitals, industry and commerce fuel and run their operations. In addition, the networks also facilitate the essential operations of power stations, transport modes, and low carbon supply resources such as biomethane and hydrogen.

The transition is an evolving area with fundamental changes required in technology development, energy policy, consumer behaviour and strategic planning of delivery, all required to ensure the most affordable, sustainable and secure energy supply to meet all consumers' needs. Hence this appears a prime area for focus for behavioural incentives for coordination and developing and sharing best practice.

Without such an incentive the risk is that different parties will focus on their own organisational or sectoral goals without seeing the value in coordination and sharing of best practice. The streetworks collaboration incentive is a great example of the power of an effective mechanism.

How might a coordination incentive work?

What type of incentive?

There is regulatory precedent for creating time limited positive incentivisation in areas which are recognised as being essential to consumers but where coordination and best practice is evolving. In RIIO-1 Ofgem developed a Stakeholder Engagement Incentive Scheme (the SEIS) across all four sectors of gas and electricity transmission and distribution. This created a set of criteria that companies would be judged against, and that defined behavioural areas that Ofgem wanted to see developed, but where there was not a clear measurable standard that could be easily referenced. Instead, they employed an expert panel of independent advisors who assessed companies' performance against the criteria and rewarded companies that had created clear strategies to engage, implemented activities that had driven real consumer value, created new ideas and shared and helped others to implement best practice and created ways to measure progress. Similar positive incentivisation was also implemented in environmental areas for the electricity distribution companies in RIIO-1 and a similar behavioural incentive has also been implemented for the Distribution System Operators for RIIO-ED2.

Our experience of the SEIS was that this positive incentive had a galvanising effect on stimulating us to revolutionise the way we approached stakeholder engagement and drove a step change in our

strategy, operations and collaboration in this space. It embedded this as a key priority for the business and developed a number of innovative practices that are in place as business as usual today. This has driven real benefits to consumers and created new and improved business as usual processes.

Our proposed approach

Our idea for an incentive in the Net Zero Transition coordination incentive is as follows:

1. Define the measures

A set of critical areas of the Net Zero transition which will deliver the most consumer value and which require coordination and collaboration to define new and best practice would be defined.

Our initial view of ideas that could be considered for the outcome areas would be:

- Innovative and inclusive consumer research and insights to inform the transition (and specific coordination with suppliers and across the industry)
- Ensuring vulnerable customers are not left behind in the transition (through driving fair charging, information to make good decisions etc)
- Supporting the development of whole system national and regional strategic planning (proactivity and impact of interactions with the NESO)
- Facilitation of biomethane, and hydrogen blending resources (coordinating to make things easier for the sector and proactivity to solve problems)
- Supporting cross sector energy resilience (working with electricity and water sectors to coordinate interactions)
- Coordinating to supporting climate change adaptation (coordinating with other sectors such as water on key risks)
- Coordinating digitalisation across sectors (digital twin integration and use and removing duplication)
- Supporting the development of market and regulatory frameworks for Hydrogen (proactively driving the creation of new codes and arrangements and solving industry problems)

2. Assess performance

Ofgem to use an independent expert panel to assess networks performance on delivering against these criteria periodically. Our view is that annually may be too frequent for this to be judged effectively so our initial thought is that this might be assessed twice over the price control period (maybe after year 2 and year 4 of the control).

Some ideas of the key assessment criteria could be:

- What outcomes have been delivered for consumers and stakeholders (this could be money saved, duplication avoided, time saved etc)
- how well content and ideas have been shared and how well was the coordination process followed
- How has this been proactive in establishing best practice
- how actions have established good behaviours and clear roles and responsibility going forwards

The key will be to assess outcomes and learnings (good and bad) that have been delivered rather than the scale of activity as well as the level of proactivity in driving the outcomes.

The assessment criteria would also need to test that this is not duplicating incentives in other parts of the framework.

3. Define the reward

Our view is the value of this to consumers is in a reward only incentive (as licence obligations will determine minimum standards in delivering services) and an initial view of the strength would be that it should be up to a maximum of 0.25% of annual revenue (this is roughly half of what the SEIS incentive was each year in RIIO-1). If this was only assessed in two years of the control rather than annually over the 8 years of RIIO-1, this in effect would be an eighth of the incentive income available over the price control (0.25×2 vs $0.5\% \times 8$). We think this would reflect the concerns raised with the SEIS by Ofgem post RIIO-1 around the scale of incentives on offer and the nature of the annual assessment.

What are the key design questions for such an incentive that need further development?

We are continuing to work on developing this incentive proposal with our independent Customer Challenge Group and would welcome an ability to develop this further with Ofgem and the sector. We believe the key questions to further develop are:

1. Refining the specific criteria to be covered by the incentive
2. Identifying any metrics that exist that could be used to support assessment and monitor progress
3. Identifying who would be best placed to be the independent panel members
4. Determining how frequently performance should be assessed, annually, bi-annually, middle and end of RIIO3
5. Determining the strength of the incentive

OVQ22. Do you have any views on our proposals for the NARM framework?

There are elements of the RIIO-GD2 NARM framework which need to be finalised to determine if the NARM framework is fit for purpose for RIIO-GD3. In particular, consultations and decisions are awaited on the incentive mechanisms around clear identifiable over/under delivery and long-term risks. These consultations should be concluded ahead of the publication of Sector Specific Methodology Decision and the Business Plan Guidance. They were due to be completed during the early stages of RIIO-GD2 but have been delayed. Therefore, it is critical that Ofgem conclude these consultations urgently to avoid a repeat of the situation seen in RIIO-GD1 where the NOMs methodology was not finalised until after the price control period had finished. We also recommend that a key objective for the RIIO-GD3 NARM framework, that it is finalised before the control period begins.

During recent RIIO-3 NARM Working Group discussions a wide range of concerns have been raised by companies regarding the existing NARM framework. These concerns have included the potential for significant (£100s millions) windfall gains or losses due to the current funding mechanism and the disproportionate level of reporting requirements within the NARM RRP. These concerns vary by sector and highlight that achieving commonality across sectors will be very difficult and could introduce significant risk of unintended consequences. As such, when shaping the NARM framework for RIIO-3 Ofgem should ensure that there is a fit for purpose mechanism for each sector, rather than seeking to achieve commonality across all.

For the Gas Distribution sector, beyond finalising the RIIO-GD2 framework, we agree that only evolutionary updates would be required to the NARM framework. These updates should include:

- Exploring the opportunities to simplify, and reduce regulatory burden from, the NARM mechanism (inc. reporting – which GDNs have asked for a consultation on to remove non-value add areas);

- Exploring the use of some common values, such as the social cost of carbon, within the NARM methodology to support a better understanding of cross sector cost benefit analysis where possible;
- The descope on non-applicable assets (such as housings) from NARM;
- The removal of reactive work from NARM;
- The removal of LTS work from NARM for all GDNs;
- Considering the removal of mandatory <2" Steel mains replacement work from NARM; and

We look forward to further working group discussion ahead of the SSMD to engage on, and progress, the areas highlighted in this response.

OVQ23. Do you have any views on our proposed long-term approach to embedding climate resilience, including the principles for embedding climate resilience?

Delivering a resilient network to keep the energy flowing safely and reliably is a core section of our Gas Safety (Management) Regulations Safety Case, a key output within our business plan and includes managing network asset risk for now and in the future.

As a provider of critical national infrastructure and essential services, our customers rely on our ability to provide a 24/7 service. Changes in the external landscape and our resilience to those changes, including climate resilience, is a principal risk to our operations. For example, our pipelines near or crossing water courses may become more susceptible to damage caused by flood waters and erosion should there be changes in rainfall and sea levels. Likewise, our Above Ground Installations may become more susceptible to the effects of increases in temperature, in particular the risk of damage caused by wildfire during droughts and extreme temperatures.

Overall, we agree with the proposed long-term approach to embedding climate resilience. We also agree that the proposed approach will take time to embed (e.g., valuing costs and benefits of adaptation actions). Resilience to climate impacts can be achieved through two main routes, 'resilience by design' and 'resilience by response'. Whilst new and replacement assets can be built with future climate resilience in mind, employing this level of resilience by design, across our asset base, will take time to adopt and evidence. In the interim we are therefore supportive of development of resilience through response. Over time a combination of preventative measures and controls will be required to manage climate event risks to ensure the resilience is delivered in an efficient and effective manner.

We would welcome clarity to ensure that a common level of resilience, including climate resilience, is in place across the energy sector, in terms of its objectives and metrics. We believe alignment between government agencies (Ofgem, DESNZ, DEFRA) is key to achieving this such that there are no conflicts between the desired level of resilience and risk reduction and allowable funding for interventions. We also would welcome clarity from Ofgem on what constitutes a reasonable cost for resilience interventions, common understanding of under what conditions climate resilience justifies interventions as a primary driver for investment.

The proposed strategic principles for managing climate resilience resonate with our own strategies. We recognise a need for forward looking data and information to systematically inform investment decision making. We acknowledge that a range of controls are required to manage climate event risks which are cost effective and proportionate to risk, ensuring best value for our customers.

OVQ24. Are there any early learnings we should be aware of/incorporate to make progress on this in RIIO-3 or beyond?

We would welcome a collaborative approach for climate resilience to ensure that a balanced view is in place when responding to climate resilience across the energy sector. Our view is that a collaborative approach will ensure clarity on scope and performance benchmark which recognises the real-world challenges inherent within the energy sector.

We recognise that the diverse topography of our networks affects the frequency and consequence of climate events on our assets. We believe these factors need to be considered when developing resilience metrics.

Our assets interactions with other non-energy sector assets managed by stakeholders include the canals and river trust, highways agency, and network rail. These stakeholders will be similarly affected by climate change events. It is important that the correct climate resilience interventions are in place for both sets of assets as there is risk of interaction between the two. Where there is a common need to assess and increase resilience of assets, there may be efficiencies applying these geographically rather than by sector.

Our assets rely on a level of protection being afforded by Environment Agency Flood Defences; it is expected that these assets will be maintained to a level in order to protect our assets.

There is a real need for open & available data to model the interaction between energy sector assets and climate events so that appropriate assessments can be made. These data sets should be consistent with the future looking scenarios that need to be modelled. For example, we are aware that the Environmental Agency data (NAFRA 1) for flood analysis only considers current scenarios, whereas the impending NAFRA 2 will consider future scenarios.

We see the potential for conflict between Ofgem and other governmental departments (including DESNZ and DEFRA) and encourage the climate resilience group to include those governmental stakeholders to ensure consistency. We are conscious that climate resilience interventions will need to be consistently applied with appropriate levels of funding to make them achievable.

Finally, there is potential that new data sets may be required to understand the developing climate resilience risks to our assets which is not currently being met by either Cadent or any other third-party data provider. Where this is the case there will need to be consideration of how this data is gathered, stored and utilised. For Cadent specifically, where these data sets are identified there is likely to be cost to deploy which will need to be considered.

OVQ25. Do you agree with our suggested approach for embedding climate resilience into RIIO3, namely: introducing resilience strategies; developing forward-looking resilience metrics; and introducing climate resilience working groups?

Damage from natural environmental conditions including lightning, wind, sunshine, snow & ice, and flooding is already a recognised threat in our safety case with a series of preventative measures and risk controls to manage the risk. We are supportive of the approach and the proposed resilience reopener owing to current levels of uncertainty and gaps in data referenced in our response to OVQ24. We expect a range of interventions to be required, ranging from capital intervention, process intervention through to enhanced emergency preparedness. We welcome the opportunity for shared industry learning to shape our future plans.

We support in principle the continuation of climate resilience working groups and currently participate with the other networks in this area. We welcome a discussion to agree how this could be built upon moving in to RIIO-GD3. We encourage a collaborative cross industry working group as we believe this will bring much needed clarity and consistency in the way that the energy sector measures and responds to climate resilience events. We also consider engagement between Ofgem and other governmental department to be an important part of this process.

Our view is that forward looking resilience metrics needs to be shaped by the climate resilience working groups. This will ensure that the metrics are sufficiently well-defined and consistently understood by the energy sector.

OVQ26. Do you agree with the proposals that we have set out around the resilience metric?

We agree with Ofgem that resilience is becoming an increasingly important issue and that it is important that networks have a robust understanding of their resilience risks and are funded appropriately to maintain acceptable resilience levels. **On that basis, we are supportive in principle of the creation of a broader resilience metric.** A well-designed metric could clarify expectations, inform companies' decisions and support the justification of our costs. It would also provide greater transparency to key stakeholders.

That said, we make the following observations which should be considered in developing the metric:

- **There is a risk of creating a bias towards the risks and activities included in the metric** – It can be expected that only risks or activities that are well understood and easier to measure are included in the metric. The metric could create a bias toward those risks and activities that are included/understood and divert attention away from other risks which will be ignored.
- **The purpose and added value of the metric should be clarified** - It will be essential that Ofgem clarifies the purpose of the metric to inform its design, for example if it is to support funding companies for resilience, check companies' compliance with future resilience standards and/or incentivise companies to maintain appropriate resilience levels. In doing this, it should be clear to Ofgem and stakeholders that a new metric would add value compared to other existing metrics, in particular NARM and a new climate resilience metric.
- **A metric alone will not drive behaviours** – Resilience is a complex and multi-faceted issue. Companies need to understand a large range of risks, forecast uncertain futures, understand co-dependencies with other utilities and identify actions needed and measure their impact. A metric alone will not support the development of a robust and systematic understanding of resilience issues in networks. In line with the recommendations of the NIC, we think companies should develop long-term resilience strategies, of which the broader resilience metric would be an input.¹
- **The scope of the metric will be challenging to define** - A "broader resilience metric" would presumably include a wide range of resilience risks (including risks resulting for co-dependencies between utilities) and span our activities to prepare, respond and recover. This will be difficult to capture in a single metric, so that a dashboard or scorecard may be more appropriate.
- **As recommended by the Business Continuity Institute, an appropriate approach would be to focus on impacts rather than risks.** It intuitively makes sense to focus on the impacts organisations might have to manage than the risks that caused them. For example, organisations should focus on developing effective responses to a fire on their assets, regardless of what might have caused it. Focusing on the impacts of any disruption to an organisation, rather than risks alone, ensures that control measures can be implemented to protect all aspects of the business. This approach is also in line with best practice, for example

¹ National Infrastructure Commission, 2023, Second National Infrastructure Assessment

ISO 22301 Security and resilience – Business continuity management systems and ISO 22317 – Associated technical specification.

- **Any new metric should be consistent with the broader framework** – Any new metric should be consistent with other related metrics, for example NARM and the climate resilience metric. In the longer-term, we think a broader resilience metric should be embedded within NARM.

OVQ27. Do you agree with our proposals on workforce resilience?

We agree that it is critical for network companies to have a modern, diverse, high quality, well-trained workforce fit for the future. On that basis we are supportive of exploring what key workforce resilience metrics could be adopted or developed. Well-designed metrics could identify and monitor company and wider-industry challenges, support the justification of company/industry action, provide confidence in the industry and enhance company reputation. It would also provide greater transparency to key stakeholders.

Significant work and engagement will be needed to identify suitable metrics but some early thoughts on potential metrics that could be explored include:

- On the status of gas safe engineers across the wider gas industry (i.e. not just GDNs). This could include the overall number, the age profile and the number of new trainees.
- Utilising the existing EDI benchmarking developed through EU Skills and already used by Ofgem and the ENA.
- Rolling out the ethnicity pay gap that Cadent reports across all network companies.
- On how GDNs are creating the hydrogen workforce for the future.

When considering workforce resilience more broadly in the context of setting the price control, it should be recognised that having ex ante certainty on workload and allowances can support with workforce resilience.

Whilst we are supportive of the targeted use of uncertainty mechanisms to manage risk, the certainty of ex ante allowances supports early engagement of the supply chain and supports workforce resilience.

Workforce resilience is likely to become an increasingly difficult issue for the whole gas sector whilst there is uncertainty on the scope and scale of its future.

The positive confirmation from DESNZ and Ofgem on the continuation of the iron mains replacement programme provides confidence to our supply chain, where we will be competing with other large, long-term programmes of work across electricity and water.

However, with progress in mains replacement activity we are already seeing a shift in the make-up of our emergency work towards in-house customer issues. If there is a reduction in the number of gas safe engineers, through a combination of retirement and low attraction for new trainees, due to uncertainty over the future of the industry it is likely to impact on in-home safety and the customer experience. For example, if a GDN attends and needs to isolate the gas supply due to internal issues but the customer is unable to source the services of a gas safe engineer in a timely manner.

As such, consideration will be needed on what funding and mechanisms are needed within the RIIO-3 framework to address these broader workforce resilience challenges.

Truth Telling and Efficiency Incentives

Key Messages:

We agree with the objectives for ambition setting incentives set out by Ofgem and we stress that transparency and proportionality are key in the assessment of the options.

We support the proposal to streamline and reduce the minimum requirements to focus on what is really important to customers. We suggest a simpler 'in the round' assessment of plan quality is considered where Ofgem look to reward new or high-quality ideas that move the service proposition to customers forward. Bespoke or new ideas in plans could be recognised and incentives or PCDs set for the companies to deliver within control with a reward for good performance.

We support the removal of a high/lower confidence breakdown and assessment. Very strong incentives exist on cost efficiency already through the setting of cost allowances based on the stretching benchmark assumption of upper quartile or 85% percentile network efficiency. This sets a strong penalty regime for plans being greater than the benchmark as the difference is catch-up efficiency. We would support some positive incentive for networks that set the industry benchmark.

From our customer insight, we have no evidence to suggest that fundamental change is needed to the sharing of totex over or under performance and we suggest that a simple 50% is applied to all. The use of the RAM provides a means to manage risks to consumers and networks for significant deviations in costs either up or down by giving a greater share to customers outside of the threshold.

We do not believe the title of these incentives as "truth telling" is the appropriate description. The incentive should be relabelled as output ambition and efficiency incentives.

OVQ28. Do you agree with our proposed key objectives for truth telling and efficiency incentives?

We agree with the objectives for ambition setting incentives set out by Ofgem and we stress that transparency and proportionality are key in the assessment of the options.

We support that a set of clearly defined minimum standards of what customers should expect from a business plan should be established and that there should be a consequence if these are not delivered. We also support that consideration be given to incentive rewards for networks that show greater ambition on outputs or services offered to customers or on cost efficiency. However, in designing any incentives Ofgem should ensure that they are confident they have a robust mechanism to ensure they are making fair comparison between companies' plans.

We do not believe the title of these incentives as "truth telling" is the appropriate description. The incentives being referred to are associated with whether there is a reward for ambition shown in the stretch on output performance or cost efficiency or penalties for not meeting minimum requirements of the information or services offered to customers in a business plan. The incentive should be relabelled as output ambition and efficiency incentives.

OVQ29. What are your thoughts on our proposals relating to minimum requirements under an evolved BPI approach?

We support the proposal to streamline and reduce the minimum requirements to focus on what is really important to customers. Our experience from RIIO-GD2 was that minimum requirements expanded to cover every aspect of the business planning process and it was difficult to determine exactly what were minimum requirements and a lack of focus on the relative importance of elements. This led to a highly time consuming and complex process for all parties involved to document and assess compliance with minimum requirements.

We support that the focus should be on completeness not on quality for the assessment of minimum requirements. It will be key that requirements are made clear with time to respond in the plans. It would not be appropriate to assess a plan as not being complete if the company has not had sufficient time to understand a minimum requirement and incorporate it into plans. In our responses to OVQ9-11 we note the importance of sufficient time to assess and accommodate any changes to underlying assumptions such as future supply/demand scenarios into the business plan submissions.

OVQ30. What are your thoughts on an 'in the round' assessment of cost forecasts as opposed to a high/lower confidence breakdown and assessment?

We support the removal of a high/lower confidence breakdown and assessment.

For Gas Distribution, the vast majority of costs are assessed through comparative benchmarking around well-established work activities and customer outputs. Clear rules can be determined ex ante around what cost elements are not appropriate to include in the comparative assessment and hence be separately subject to technical assessment.

Hence for this reason, we see little value in differentiating high/low confidence costs for Gas Distribution. This is reinforced by the fact that the outcomes of the RIIO-GD2 assessment of high/low confidence costs resulted in very little differentiation in TIM rates between GDNs.

We would not characterise the comparative benchmarking as an 'in the round' assessment but a more quantified approach to setting an industry benchmark. In addition, Cadent received very positive feedback on our engineering justifications for RIIO-GD2 for technically assessed costs and this is governed by a clear engineering justification proposal process, so we do not see a need to add any additional process to the business plan assessment.

To support this, we advocate a simple setting of a 50% sharing factor for costs as we see no sufficient new evidence to depart from this RIIO-GD2 position/approach. We note that the Return Adjustment Mechanism provides a natural adjustment to the sharing of costs as the extremes of if performance differs materially from the cost allowance assessment. We suggest in our response to FQ28 that we think the RAM thresholds could be assessed against the overall risk structure of the price control framework (for example a narrowing could reduce risk for all parties).

OVQ31. What are your thoughts on an 'in the round' assessment of business plan ambition as opposed to requiring and assessing CVPs?

The principle of Customer Value Propositions was a good idea to determine a quantifiable measure that reflected consumer value. However, in practice Ofgem struggled to apply it effectively as part of the Business Plan Incentive. The RIIO-2 GD and ED experience was that very few CVPs were accepted despite there being a large range of proposals made and significant consumer value identified. We recognise the challenge Ofgem has in giving large ex ante rewards to companies for their plans as this locks-in costs to consumers and then requires a process to assess whether the benefits of the CVP proposals have been delivered. It is notable that Ofgem also did not feel confident enough to Fast Track any networks in Gas Distribution in the RIIO-1 price control business plan incentive.

We suggest that this challenge of objectively assessing quality upfront is recognised in how any quality incentive reward is defined. We do not believe a widespread "in the round" assessment such as that which Ofwat is undertaking for PR24 is optimal in that it would drive a need for significant time and evidence of a comparative assessment of quality and potentially then creating the challenges that Ofgem came across in applying the CVP methodology. We suggest instead that a simpler 'in the round' assessment of plan quality is considered where Ofgem look to reward new or high-quality ideas that move the service proposition to customers forward. Bespoke or new ideas in plans could be recognised and incentives or PCDs set for the companies to deliver

within control with a reward for good performance. This would ensure rewards are linked to actual delivery and would enable ongoing improvement to be encouraged through the price control.

OVQ32. What are your thoughts on the size and strength of any truth telling incentive?

Ofgem should look at the overall range of incentivisation over the price control and look to deliver a framework that does not unduly create downside risk to investors and does contain some upside potential for positive performance to ensure that investment is encouraged in the sector and cost of capital delivered efficiently.

With that backdrop, we think that Ofgem should recognise that it will be difficult to justify significant upfront business plan incentive rewards prior to companies delivering them.

Very strong incentives exist on cost efficiency already through the setting of cost allowances based on the stretching benchmark assumption of upper quartile or 85% percentile network efficiency. This sets a strong penalty regime for plans being greater than the benchmark as the difference is catch-up efficiency.

We would support some positive incentive for networks that set the industry benchmark. The RIIO-2 mechanism does this through giving the difference between the network plan and the benchmark upfront. An alternative to this could be to develop an ex-ante reward through an Information Quality Incentive type matrix however we note the drawbacks that this could be seen as a less transparent mechanism and overly complex.

On the quality incentive strength, we would support a positive incentive but as in practice Ofgem to date has not determined they can make any material rewards at the upfront stage, we would suggest that a more realistic articulation of what is a real upside potential be set out and focus put on the within period incentives where it may be easier to quantify and measure benefits delivered.

Figures OVQ32.1 and OVQ32.2, below, show the maximum and average BPI reward/penalty received in RIIO-2 by sector. It shows that whilst Ofgem's stated potential range was $\pm 2\%$ Totex, very limited upside was provided across all sectors at both a leading and average company level. We believe that this is reflective of the challenge that Ofgem faces in having confidence in providing upfront rewards. We note that the penalties applied were of a greater level than the rewards. This realistic profile of providing rewards or penalties through the BPI should be reflected in the overall RoRE assessment of the framework and suggests a downside skew.

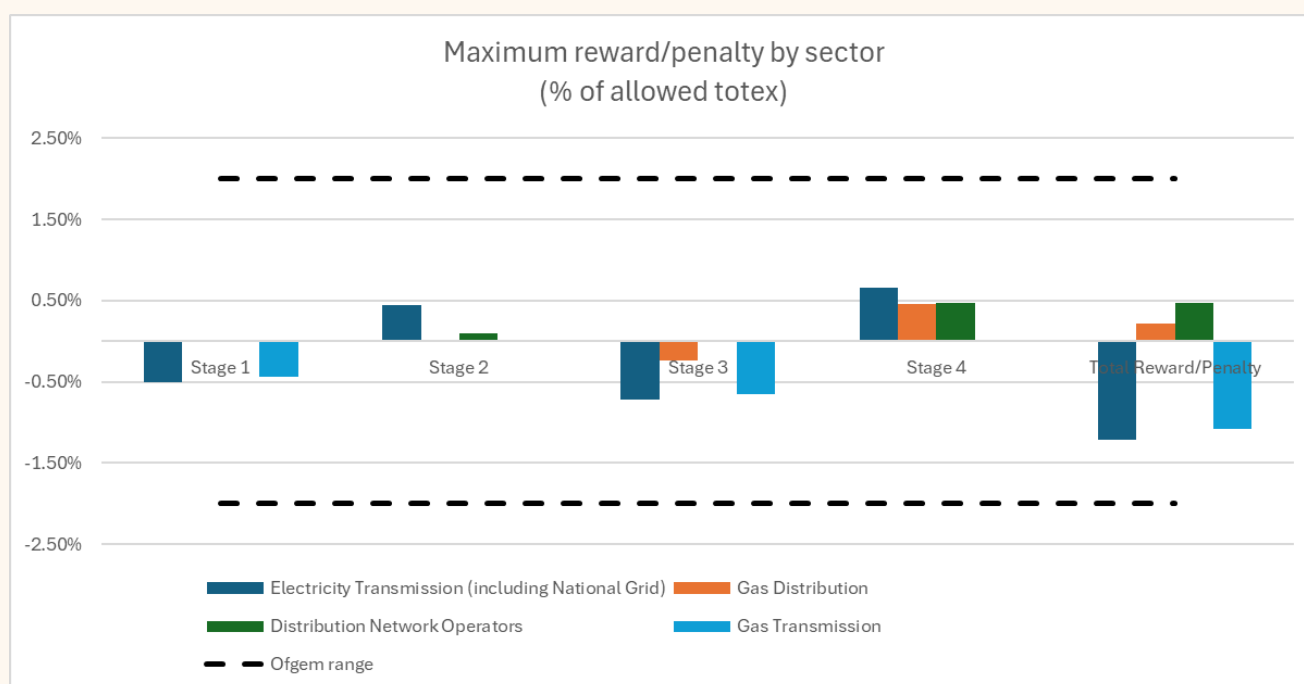


Figure OVQ32.1: RIIO-2 maximum BPI rewards/penalties applied by sector

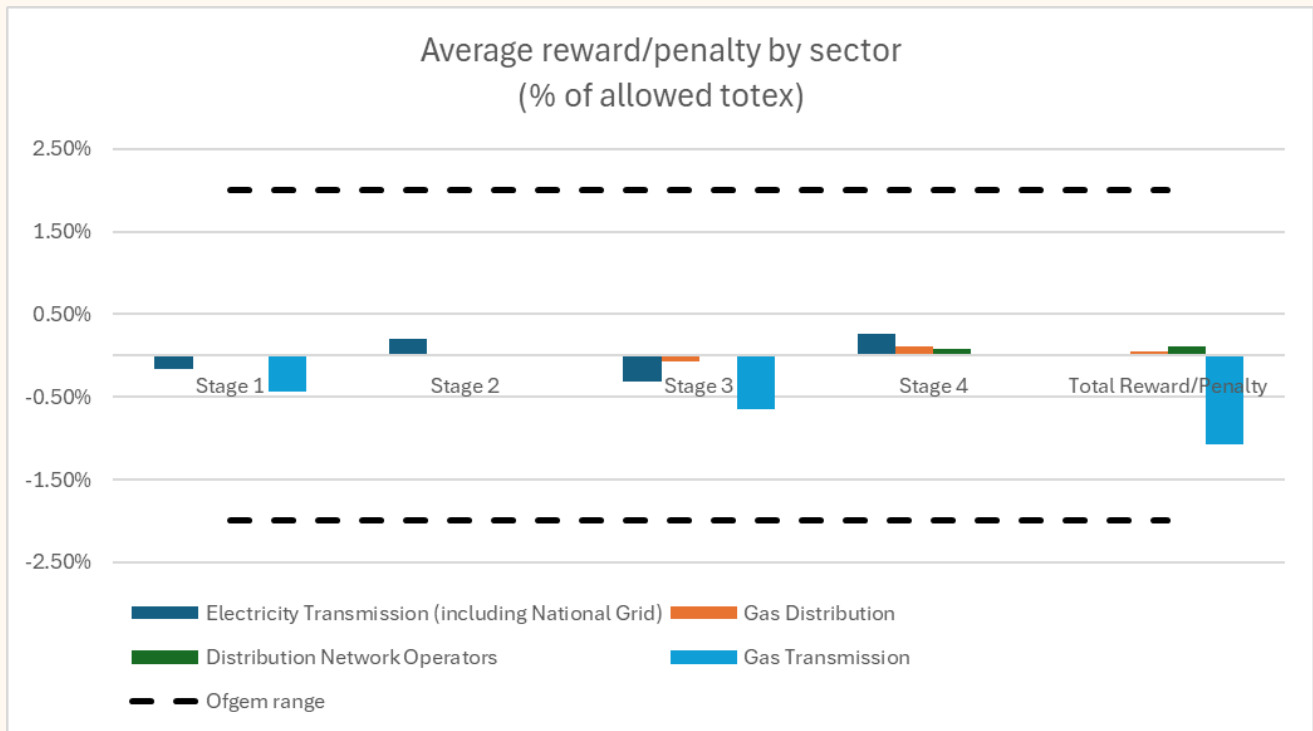


Figure OVQ32.2: RIIO-2 average BPI rewards/penalties applied by sector

OVQ33. What are your thoughts on any alternative approaches that could be used instead of an evolved BPI?

We provided some suggestions in the industry workgroups as to how an Innovation Quality Incentive type matrix could be applied for costs to augment the comparative benchmarking approach and positively incentivise networks to set the industry benchmark with their forecasts.

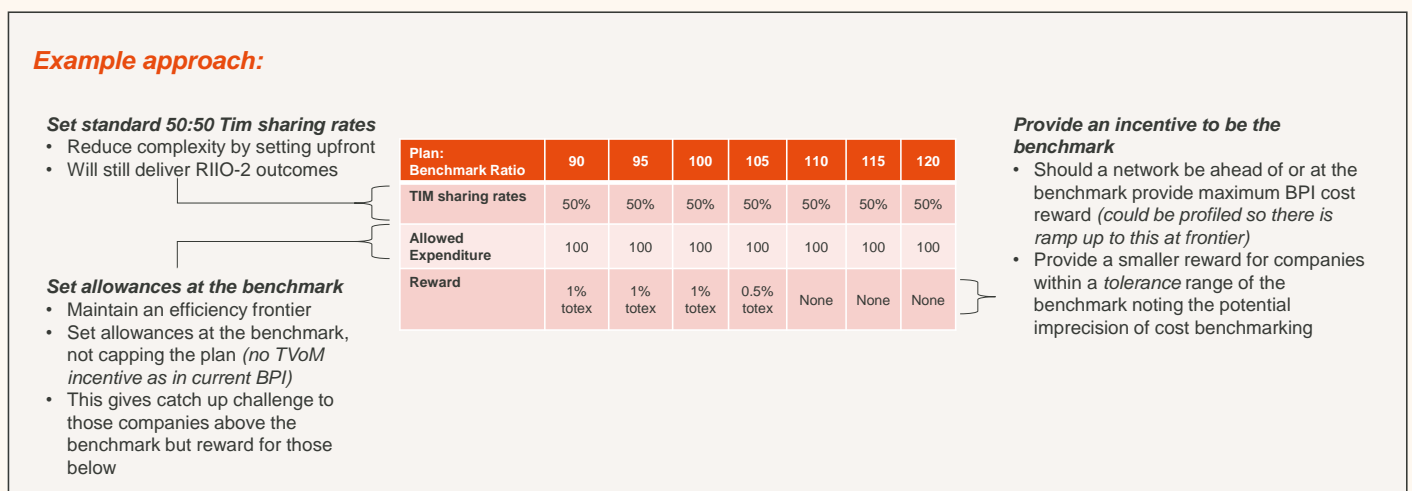


Figure OVQ33.1: Example BPI approach

We note that in practice it may be difficult to determine what the reward levels should be. If so, we would suggest Ofgem continue with the Stage 4 process they applied for RIIO-2.

There is a strong negative incentive already through catch up efficiency if your plans are off the benchmark hence, we see no rationale for adding additional penalties.

OVQ34. What are your thoughts on the options for calculating the sharing factors and do you see strong reasons for changing the overall strength of the sharing factors relative to RIIO-2?

From our customer insight, we have no evidence to suggest that fundamental change is needed to the sharing of totex over or under performance. We suggest that a simple 50% is applied to all. The use of the RAM provides a means to manage risks to consumers and networks for significant deviations in costs either up or down by giving a greater share to customers outside of the threshold. In line with our comments on the overall calibration of risk and reward in the RIIO-3 RORE range, we believe the RAM thresholds should be considered and set at levels which manage those risks but enable confidence to set financial output delivery incentives that customers will value and enable a sensible level of expected reward or penalty on totex performance. For example, a narrowing of the RAMs thresholds could be considered to ensure that customers and networks are insulated from the risks of miscalibration of the totex benchmark and to not overly constrain output incentives that customers value as shown in Figure OQ34.1 below. This could be a particularly useful measure given the step change in input prices seen in RIIO-2 and ongoing economic climate and hence the volatility in potential costs and the enable some additional incentivisation than the heavily constrained RIIO-GD2 framework.

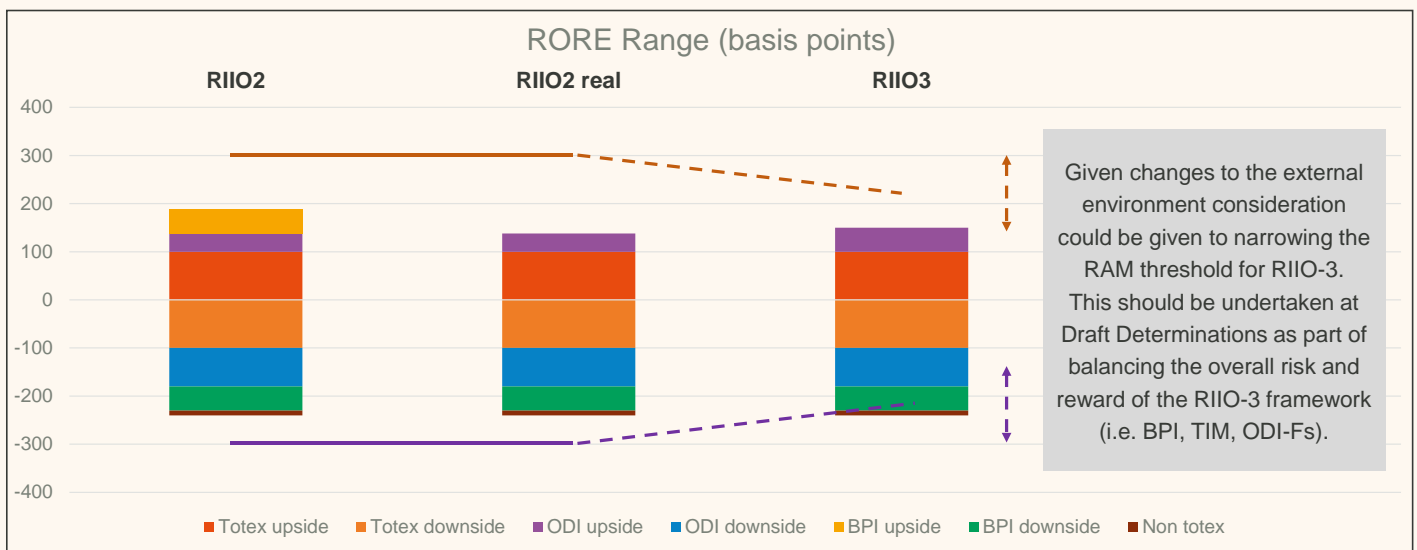


Figure OVG34.1: Illustrative RAM threshold change

Managing Uncertainty

Key Messages on the toolkit:

The existing RIIO toolkit to manage uncertainty, including indexation, pass-through mechanisms, volume drivers, use-it-or-lose-it allowances and re-opener mechanisms, remains broadly fit for purpose for RIIO-GD3. These tools are most effective when they are well targeted to the uncertainty they are seeking to manage, including the speed of response required, as well as being effectively scoped and calibrated to ensure that networks can respond to evolving requirements.

We broadly agree with the principles, set out in paragraphs 8.2, 8.3 and 8.4 of the SSMC, for the application of mechanisms to manage uncertainty. However, we believe there is a need for an evolution of the uncertainty toolkit to ensure that the framework is as agile as will be needed and that it more appropriately balances the risk and burden associated with managing uncertainty.

Whilst re-opener mechanisms are valuable in being able to manage scenarios where the needs case and/or scope of projects is unclear, they can be slow and burdensome processes for both Ofgem and companies. As such, consideration should be given to the introduction of an additional materiality threshold to differentiate between lighter scrutiny and heavier scrutiny costs to reduce the burden associated with some applications and with the objective of speeding up the assessment of all applications.

We illustrate how this could potentially work in the diagram below. It shows that applications that exceed the first materiality threshold (or where no materiality threshold is used – for example in safety related re-openers), but do not reach the second threshold would have their needs case assessed but would not be subject to cost assessment, instead a clearly scoped use-it-or-lose-it allowance would be applied. Where an application exceeded the second threshold it would be subject to full assessment.

This would reduce the burden on Ofgem to undertake full detailed cost assessment on every application. It would speed up the assessment process for many applications which would only require needs case assessment. It would also, by reducing the number of applications needing full assessment, potentially free up Ofgem resource to focus on these more material costs, potentially more strategic, applications for heavier scrutiny, and thus be able to undertake the assessments in a shorter timeframe. This will also reflect a proportionate approach to protect consumers.

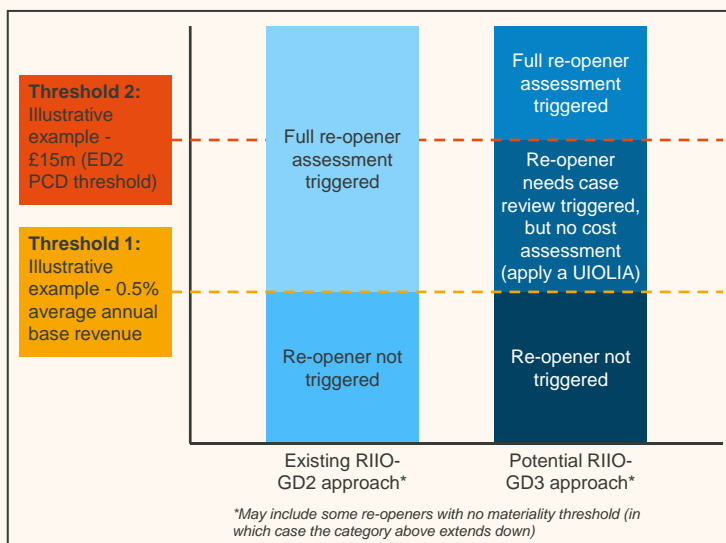


Figure MU.1: Introducing an additional materiality threshold for re-opener mechanisms

We support the continued use of indexation to support the adjustment of allowances up or down to take account of general price changes. However, it is important that this is supported by an accurate Real Price Effects mechanism to take account of specific cost pressures more relevant to GDNs which can diverge significantly from underlying general inflation. We have set out our initial thoughts on areas for improvement of the current RPEs mechanism in our responses to OVQ44.

Finally, it is important that the SSMD, and the business plan guidance, recognises that there will be new areas of uncertainty identified between now and business plan submission. As such, there should be opportunity for networks to identify these areas in their business plans and they should be consulted on at Draft Determinations.

OVQ35. Do you agree with our proposal to retain the Net Zero Re-opener with its current scope and parameters for RIIO-3?

We agree with retaining the Net Zero re-opener with the same parameters as in RIIO-2, where it was Authority triggered with a materiality threshold of 0.5% of ex ante base revenue. We would request it is reviewed however to ensure it has the necessary flexibility and scope, and that the operation of the triggering process is effective and efficient for all parties.

OVQ36. What are your views on our proposal, in principle, to retain the Net Zero and Re-opener Development Fund UIOLI for RIIO-3? What are your views on the types of projects it could fund and how it would interact with other sector specific price control mechanisms?

We fully support the continued use of the Net Zero re-opener and development fund UIOLI. It has clearly met its original design brief to allow critical net zero enabling works to continue at pace, where they do not otherwise meet the criteria of other mechanisms.

In our answer to OVQ4, we have suggested the need for a new uncertainty mechanism for RIIO-3 that would build on the benefits of this UIOLI flexible funding, but recognise the role Government, Ofgem and the NESO will have in triggering GDN activities, with outputs required at pace. Such a new mechanism would need to be coordinated with this UIOLI to ensure it is understood what work sits where. A new mechanism would impact the level of funding required for the UIOLI. An example for funding through UIOLI would be new activities triggered by Ofgem/Government/NESO.

OVQ37. Do you think we should retain the NZASP for GD and GT? What should its scope be and what kind of projects would you expect to be funded through this re-opener in RIIO-3?

We agree in principle with retaining the NZASP for RIIO-3. Its current scope has worked well however changes in other areas would trigger a review of the NZASP scope to avoid duplication or creating any funding gaps.

The current scope is flexible, and could cover larger regional planning initiatives, including detailed coordinated plans and design for conversion away from methane use.

OVQ38. Do you have any views on consolidating the net zero related re-openers and the UIOLI allowance?

We do not have strong views about the consolidation of mechanisms, so long as they do not reduce possibilities for companies to seek additional funding to respond to unexpected changes in circumstances.

The Net Zero Re-opener was designed as a catch-all where other more targeted funding mechanisms could not be deployed. Any changes must recognise this original design principle.

We note the possibility that a new consolidated mechanism could turn out to be more complex than several, simpler mechanisms.

Without clear benefits for change, for simplicity and to minimise workload, it may be prudent to retain the existing structures. The UIOLI allowance, in particular, has been a hugely valuable tool allowing vital net zero re-opener development work, which has allowed critical net zero supporting projects to move forward at pace. The suite of UMs including the UIOLI should be protected and built on going forwards as to do otherwise would risk failing Government targets, carbon budgets and the overall decarbonisation of the energy system by 2050.

OVQ39. Do you agree with our proposed position to retain the Coordinated Adjustment Mechanism for RIIO-3? If it were to be retained, what design and incentive considerations could we implement to enhance the utilisation and value of this mechanism?

We do not believe the design of the Coordinated Adjustment Mechanism (CAM) will enable the desired whole system working it was hoped to deliver. We would therefore prefer to see it turned off. In our answer to OVQ21 we have set out an alternative Net Zero transition coordination incentive which we believe would deliver greater benefits to end consumers.

OVQ40. Do you agree with our proposal to allow physical security costs to be submitted through a broader resilience re-opener?

We agree in principle with physical security costs being submitted through a broader resilience re-opener, as long as the specific terms do not reduce companies' ability to secure additional funding where needed. It is important to note that physical security is a key mitigation in response to the eCAF, so coordination will be needed with any Cyber funding. We would like the categories to be assessed to make them current for today.

OVQ41. Do you agree with our proposed approach to introduce a resilience re-opener?

We agree with the introduction of a broader resilience re-opener rather than to provide specific allowances or re-openers for specific risks. We agree a broader re-opener will give more flexibility to companies to respond to changing requirements regarding resilience while being simpler to operate for both Ofgem and companies.

While we recognise there will be a desire to precisely define the scope of the re-opener, we think it is crucial this is not achieved at the expense of flexibility. Otherwise, the re-opener will not support Ofgem's intent to provide genuine flexibility to companies.

For similar reasons, we think the re-opener should be both company and Authority triggered.

OVQ42. Do you have any views on whether the opex escalator should be retained and if so, how we could evolve the opex escalator for RIIO-3?

We have no particular views on the Opex Escalator as it does not apply to the Gas Distribution sector. However, it is clearly important that indirect opex costs associated with large capital works (similar to those covered by the escalator for transmission networks) receive appropriate and fair cost assessment for GDNs and are able to vary where needed to support funding provided for capital works granted via uncertainty mechanisms.

OVQ43. Do you have any views on how we should effectively monitor the delivery of UMs?

The existing RIIO-GD2 framework includes sufficient mechanisms for Ofgem to be able to monitor the delivery of UMs and therefore no additional mechanisms are required.

We agree with the need for consistency of cost allocation as part of company submissions. This is important not only for the administration of uncertainty mechanisms but for the fair determination of ex-ante allowances and any associated efficiency assessments.

In our view, the best way of ensuring this is through collaboration at a working level through the appropriate working groups, accompanied by clear and early guidance from Ofgem on the allocation of costs. We therefore **disagree** with the proposals presented by Ofgem. Neither of the two options set out in the SSMC are necessary given the existing arrangements and could act as a blocker to companies' ability to respond to changing circumstances in an agile manner.

Option 1: Increased governance requirements on companies providing costs and outputs submissions to Ofgem during RIIO-3

The existing procedures and controls are sufficient to protect consumers and mitigate the complexities Ofgem highlighted.

Each type of uncertainty mechanism includes robust procedures and protections for consumers, notably to justify the need case and the efficiency of costs.² The current re-opener guidance also includes a requirement for companies to "provide evidence to justify why the expenditure is additional to that already provided for by relevant ex ante allowances, or that will be provided through other uncertainty mechanisms".³ The VCMA guidance is also very clear on what activities can be delivered through the UIOLI allowance and includes requirements to document the activities being delivered. This ensures that the activities delivered are beyond those funded through the baseline.

While these procedures are necessary, they create a significant burden for both Ofgem and companies which is multiplied by the number of mechanisms in operation in RIIO. Adding further governance is unnecessary, would add further regulatory burden and could act as a further blocker to companies' ability to respond to changing circumstances in an agile manner.

² Ofgem, 2023, Re-opener Guidance and Application Requirements Document

³ Ofgem, 2023, Re-opener Guidance and Application Requirements Document, para 3.19

Option 2: adjustments to reduce the allowances under UMs to companies that are found to be repeatedly providing inconsistent data against consumers' interests

The existing RIIO mechanisms are sufficient to protect consumers and mitigate the concerns highlighted in the SSMC.

The RIIO framework already includes the tools to enable Ofgem to disallow requests for additional allowances and claw back allowances from companies, as such no additional mechanisms are required. For example, Ofgem apply significant scrutiny to company re-opener applications, including utilising supplementary question and draft determination consultation processes to clarify any concerns, and will reject all or part of an application if it has not met the requirements. Material uncertain spend is often also tied to PCDs, so if a company did not deliver what was required or delivered a solution against consumers' interests Ofgem would be able to recover some or all of the relevant allowances.

Whilst the existing mechanisms are necessary, they already create a significant burden for both Ofgem and companies which is multiplied by the number of mechanisms in operation in RIIO. Adding further mechanisms aimed at reducing company allowance could lead to a risk that they are disincentivised from responding to changing circumstances if there is even greater uncertainty whether they will be able to keep their allowances.

Cost of Service

Key Message:

We continue to drive efficiency within our networks within the RIIO-GD2 period to seek to meet the stretching allowances we have been set for the price control. However, based on current RRP forecasts, we along with all other ownership groups, expect to overspend these allowances across the period. This, together with the continued sluggish macroeconomic performance of the UK economy and the impact of significant exogenous inflationary and commercial cost pressures on our operations, means a review of current methodologies for setting the Ongoing Efficiency challenge and setting the Real Price Effects mechanism are needed. We have initial views on the areas of focus for this review which we set out in our response to OVQ44 and are undertaking work collectively with other gas transporters (GDNs and Gas transmission) to consider areas for development of RIIO-2 methodologies. We will provide further views based on this information as part of future submissions. We do not believe either Ongoing Efficiency or Real Price Effects should be applied to re-open applications, given the nature of funding being sought through these mechanisms.

OVQ44. Do you have any views on whether to evolve the RIIO-2 methodologies for RPEs and ongoing efficiency for RIIO-3, and if so how?

We are supportive of the review and potential evolution of methodologies for Real Price Effects (RPEs) and Ongoing Efficiency (OE) for RIIO-3 based on the collective experience of GDNs within the RIIO-GD2 price control and the current sector and macroeconomic environments. We are currently undertaking work within Cadent and, to support consistency of underlying evidence, collectively with other gas transporters (GDNs and Gas Transmission) to review and consider areas for development of RIIO-2 methodologies. We will include our views on how methodologies should be evolved as part of our RIIO-GD3 business plan, building on the collective evidence gathered, and through future discussion at Cost Assessment Working Groups with Ofgem. However, we set out some initial thoughts below.

Real Price Effects

We supported the introduction of RPEs for RIIO-GD2 to recognise input price movements in addition to baseline CPIH inflation. We believe the mechanism benefits our customers as well as our investors by reducing exposure to uncontrollable input price swings, risk around financing of the business and the consequential impacts on bills year-to-year – allowing network charges to rise through periods of high inflation and decline in the reverse to match costs incurred.

The RIIO-GD2 period, and most notably post the COVID-19 pandemic, have ‘stress-tested’ the mechanism with a period of high and unevenly distributed inflation which we have seen realised in different ways across CPIH and the indices that make up RPEs. It has also shown that in some areas a review of the underpinning methodology is warranted for RIIO-GD3 to ensure that RPEs accurately reflect cost movements for GDNs.

We believe there may be scope for improvement of the current mechanism, with key areas of focus for a review covering the:

- **approach to segmenting cost types for the notional GDN** – we believe there may be scope to consider improvements in how costs are segmented – both in terms of what number/type of categories that costs are segmented into in principle, and how this is then achieved in practise.

For example, transport/vehicles and plant costs could be considered for their own specific treatment at RIIO-GD3 as well as labour and materials;

- **approach to weighting different indices** – there is likely to be scope to improve the approach to weighting different indices to capture cost movements within each of the labour, materials and other cost categories also. For example, we believe consideration is needed on the appropriate weighting of materials related indices in the calculation. At RIIO-GD2 in our Draft Determination response we raised an issue with Ofgem relating to the weighting attributed to movements in structural steel costs. At the time, these only amounted to 0.4% of our actual totex, but were given a far higher weighting in the RPE mechanism, creating a distortion between cost movements RPEs would reflect and our actual cost base. We engaged proactively with Ofgem on this point between Draft and Final determinations, but this specific issue was not remedied. As we have now seen the consequences of this in RIIO-GD2 we are keen to explore alternatives as part of the future price control;
- **specific indices used to reflect the GDN cost base** – for example, the approach used at RIIO-GD2, placed significant emphasis on an index for structural steel to capture materials cost movements, which is highly variable, and which may not be the most appropriate index to utilise to reflect actual movements in our cost base. As noted above, the larger weighting attributed to this index in the RPE mechanism by Ofgem relative to spend we actually incur for use of steel only magnifies this issue by attributing a greater proportion of cost movement to a volatile index which does not reflect movements in our actual cost base proportionately; and
- **forecasting approach for RPEs** – whilst the mechanism has ‘true-up’ features, the forecasting approach utilised in the framework does impact the financing of GDN businesses due to its impact on cashflows. Therefore, review of forecast approaches would be useful such that they minimise any potential negative impact on network businesses and their customers.

Ongoing Efficiency

The RIIO-GD2 price control set ambitious and stretching cost allowances for GDNs through the application of a higher 85th percentile catch-up efficiency challenge, for the majority of networks, paired with an average 1% ongoing efficiency challenge for all GDNs per annum. This approach was taken despite very low productivity growth within the UK economy and on the back of the RIIO-GD1 period where some, but not all GDNs, saw material totex outperformance. However, we believe the continued sluggish macroeconomic performance of the UK economy and the change in outlook for RIIO-GD3 call in to question the potential for achieving a similar level of uniform efficiency gains in the upcoming period.

The determinations made as part of RIIO-GD2 for the level of ongoing efficiency reflected a broader trend across network regulators who set increasing ongoing efficiency challenges significantly above what the UK economy has achieved concurrently – prolonged flat (and near-zero) productivity growth since the financial crisis of 2008. Given that evidence shows the productivity slowdown is widespread across industries, the causes are, intuitively, likely to be more economy-wide (rather than industry-specific). The level of ongoing efficiency challenge set by regulators, including Ofgem, therefore appears counterintuitive and implies regulated companies, including GDNs, are able to outperform the UK economy, and by a greater degree now than in the past. As it is now over 15 years since the financial crisis it is clear the productivity slowdown is not transitory, and it is imperative Ofgem take this into account when determining the level of any ongoing efficiency challenge applied at RIIO-GD3. This includes setting out clear and demonstrable reasoning and evidence to justify any challenge that implies GDNs are not impacted by the drivers of the ‘productivity puzzle’, and indeed, that they are able to deliver efficiency gains significantly in excess of the UK economy at large.

In addition to the continued stagnant productivity growth within the UK economy, the inflationary and commercial cost pressures GDNs are experiencing in RIIO-GD2 present a very different sector outlook than at the end of RIIO-GD1. Indeed, as latest RRP forecasts show, there are significant upward cost pressures, and with it unlikely any ownership group will be able to achieve its initial stretching totex allowances by the end of RIIO-GD2. These pressures will continue into the RIIO-GD3 period, and in some cases only become more significant as costs for certain activities (e.g., mains replacement) are expected to increase further due to resource competition within the sector and as other sector investment programmes will be drawing from the same resource pool (e.g., water investments from PR24, fibre broadband rollout amongst others). There will also be new outputs we must deliver to, where the magnitude and type of costs may continue to be uncertain in future (e.g., such as in relation to meeting the Enhanced Cyber Assessment Framework – eCAF). This makes it more difficult to achieve continued ongoing efficiency gains, which are predicated largely on delivery of a set of known and certain outputs with reduced inputs over time.

We note that the impact of similar cost pressures have been emphasised in water company business plans for the PR24 price control. Indeed, most companies have proposed reduced ongoing efficiency challenges to below 1%, with the majority suggesting a figure closer to 0.5% based on collaborative work commissioned from Economic Insight. This work in itself suggests a ‘plausible range’ of challenge between 0.3%-0.8%.⁴

Given this, we believe a thorough review of the approach to determine the ongoing efficiency challenge is needed to ensure any challenge set is reflective of the sector and wider macroeconomic environment, which we believe limits the scope of potential efficiency gains, relative to past periods. Key elements of a review of the methodology should include:

- an assessment of the factors leading to the UK productivity slowdown and justification for why it is/is not possible for GDNs to outperform the more general level of poor productivity growth
- comprehensive analysis of a range of benchmark data sources – not just limited to external productivity datasets (e.g., ONS, EU KLEMS) and Total Factor Productivity (TFP) analysis but also more recent performance of GDNs and network regulated companies. In doing so, critically assessing;
 - the right measure of productivity growth;
 - time period;
 - comparator companies/sectors; and
 - the approach to determine a specific ongoing efficiency assumption within any estimated benchmark range.
- an assessment of the extent to which any derived estimates of ongoing efficiency challenges based on TFP overlap with catch-up efficiency challenge and requirements from Ofgem for delivery of new/improved outputs for customers within in the future price control.
- an assessment of the extent to which historical data can be relied on to set future ongoing efficiency challenges in light of current macroeconomic circumstances and ongoing cost pressures.

OVQ45. Do you have any views on the potential application of RPEs and ongoing efficiency to re-opener applications?

Re-opener applications within RIIO-GD2 apply to expenditure that has been both incurred by GDNs to date, and which they are seeking incremental funding for (rather than having spend go through the Totex Incentive Mechanism) – i.e. retrospective application, and costs to be incurred which they are

⁴ Economic Insight (2023) “*Productivity and Frontier Shift at PR24: a report on behalf of a consortium of water companies*”, see here: [Frontier shift at PR24 \(thameswater.co.uk\)](https://frontier.shift.at.pr24.thameswater.co.uk) (accessed on 14/02/24)

seeking incremental funding for – i.e. prospective application. The precise type of costs being claimed for vary from re-opener to re-opener. However, at present, whilst RPEs and OE are applied to some Uncertainty mechanisms (like volume drivers), they are not applied to re-openers – whether claimed retrospectively or prospectively.

In considering whether ongoing efficiency should be applied to re-openers within RIIO-GD3 we think it is important to focus on why re-openers are used. In particular, re-openers are used when there is not sufficient certainty over size and scope of costs to provide ex-ante funding through baseline allowances – determined either through comparative or non-comparative cost assessment approaches. The nature of these costs being uncertain is driven by the need to deliver new outputs or the need to deliver existing outputs in a different way due to significant change. Ongoing efficiency gains are predicated largely on the ability to continually deliver a set of known and certain outputs with reduced inputs over time. We think it is therefore inappropriate due to the nature of costs to expect any ongoing efficiency gains through spend claimed on re-openers in general. However, where ongoing efficiency is not applied to spend within the period and funded via re-openers, we think it is right to consider OE application for future price controls where there is sufficient certainty at the next price control for these activities to be funded via baseline allowances.

In respect of RPEs our views are similar. Clearly where re-openers are being sought by companies to fund retrospective spend it is impractical to apply RPEs. However, for prospective spend we can understand why considering RPEs could be useful. That said, as spend is driven to deliver new outputs or the need to deliver existing outputs in a different way due to significant change, it is unlikely that RPEs at the sector level will match the spend profile of funding sought via re-openers. Furthermore, we do not think that re-opener specific RPE are practical for use (as may be required) given proportionality. As such, similar to Ongoing Efficiency we do not think re-openers should have RPEs applied.

Cyber Security

Key Message:

We broadly agree with Ofgem's suggestions and the proposals to consolidate the cyber reopener guidance with the NIS supplementary guidance and reduction of the number of PCDs, but would caution Ofgem not to create unnecessary complexity in the framework process through other means such as using CAF objective level reporting, or striving for benchmarking when licencees' approaches are still maturing and developing.

OVQ46. Do you agree with our proposed approach to cyber resilience in RIIO-3?

We broadly agree with the consultation's analysis of the approach taken to cyber resilience in RIIO-2 and the proposals for RIIO-3, but would ask that the following are considered:

- We agree that consolidation of the cyber reopener guidance and NIS supplementary guidance should be considered. It should be noted that not all reopeners will be for NIS systems so there may still be some complexity in the guidance.
- As we move towards a converged IT/OT landscape it no longer makes sense to submit separate IT and OT plans. Consideration should be given to submission of a single cyber resilience plan across both IT and OT with a view of the overall business resilience being more appropriate. We recommend that plans should highlight improvements to systems within NIS Scope and those outside of NIS scope. In addition, while a templated submission structure would in principle be welcome, it would also have to cover the various types of submission and the guidance should be clear on treatment of costs for cyber and operational technologies that are now merging. Further clarity on the type and level of detail required for IT/OT plans and re-opener applications are welcome, particularly if using a triggered risk approach.
- We believe that the cost assessment of cyber costs in their totality should be undertaken separately from core comparative regression analysis, whether it be at a totex or more disaggregated level. This follows the approach taken at RIIO-GD2 and reflects the fact that cyber costs meet all the criteria to be excluded from this type of analysis (see our response to GDQ55 for more details on our proposals for criteria. Specifically: the costs are material, the current driver in the regression analysis for these types of costs is MEAV, which does not have an intuitive relationship with the size of costs cyber activities entail and, given the maturity in this area is still developing, companies are at very different stages of evolution and maturity which means benchmarking across companies is likely to be inaccurate. Ofgem and licencees are acutely aware of the complexities with benchmarking and we would caution against the additional regulatory burden this may create, in addition the risk of making baseline allowance decisions on incomparable data.
- We would welcome the retention of UIOLI and propose allowing a more agile approach to delivery.
- We agree that reducing the number of PCDs should reduce the reporting burden. A suggestion would be to have a threshold for material projects and map PCD outcomes to the 16 CAF principles (rather than the 42 individual objectives) and relevant risks.
- The move to reporting annually rather than every 6 months has been welcomed. More frequent reporting would again lead to disproportionate burdens and it is suggested that leveraging regular updates through bilateral advisory sessions instead.
- We agree that the re-opener mechanism for resilience costs (including cyber) should be reviewed. The gap in time between December 2024 and April 2026 is not ideal due to the rapid evolution of the Cyber threat landscape. We would agree with a mid-term reopener in RIIO-3 and suggest an additional one earlier, otherwise companies may have to wait four years from

December 2024 to 2028 (excluding the time it takes for Ofgem to review the reopener submission and confirm allowances, unless an Authority Triggered reopener occurs. We also agree with the approach of establishing a dedicated reopener for resilience including both Physical and Cyber controls in line with the eCAF guidance.

Innovation

Key Message:

We are fully supportive of the retention of the NIA or equivalent and we are proposing additional NIA criteria to expand its remit. We are supportive of the SIF Alpha & Beta phases in principle but not of Discovery and encourage the removal of unnecessary bureaucracy. We agree with the level of NIA funding remaining similar to that in RIIO-2, accelerators being considered and widening access to innovation funding to 3rd parties to better equip them to bring us more informed ideas and proposals but with the right controls and administration. We are supportive of additional roll-out type of funding considerations, again, with the right controls and administration. We have shared a graphic that illustrates the collaborative work done with the other Gas Networks with regards to potential innovation funding structures which is useful to review.

OVQ47. Do you have any views on our proposal to retain a flexible allowance, providing evidence for why you think that it should, or should not be, retained?

We fully support the retention of a flexible innovation allowance which is currently available under the Network Innovation Allowance (NIA), it being necessary for supporting higher risk innovation across the networks, SMEs, and Academia, that would otherwise probably not be undertaken. This type of support has a proven track record of delivering benefits to consumers and the wider energy system thereby supporting the transition to net zero.

A key benefit of NIA funding is that it provides “certainty”, it is “predictable” and a “consistent funding source”. The stable access to funding encourages the embedding of innovation and without this, there is a risk about a loss of continuity in innovation, including through the reduction and even loss of dedicated innovation teams.

NIA funding provides an agile and flexible approach to exploring innovative and flexible solutions through a range of its characteristics. These characteristics include:

- flexibility in the time taken to develop a project idea, which can be adapted according to the needs of the project.
- flexibility in the duration of the project, which allows for shorter projects to explore quick wins and test out new ideas, and projects which require investigation and involvement over longer time periods.
- flexibility in the partners involved in the project, which allows projects to involve the most valuable relevant stakeholders and bring them on board at a time that most suits the project development.
- flexibility in managing changes to the project, we know that innovation is not a linear process, so whilst NIA projects are bound to scope, budget, and timeline agreements initially, appropriate change control exists so things can adapt as the project progresses to respond to developments that occur.

We would also support a review and refinement of requirement 1 within the current NIA governance (NIA section 3.6, Requirement 1 – facilitate energy system transition and/or benefit consumers in vulnerable situations) to potentially include three more specific additional areas, both of which broadly support the Energy Systems Transition aspect but we feel need to be more prescriptive to ensure continued clear and visible compliance.

1. Resilience – Network, Workforce and Climate – All of these are mentioned in other sections of this SSMC response in significant detail, the solutions needed to tackle all these areas will require consideration of innovative solutions that are unproven generally or within our industry.
2. Net Zero Construction – To continue to look at new innovative solutions for decarbonising our construction operations throughout our supply chain, we need to develop greater understanding and learning to assess both viability and cost implications.
3. Emissions – To continue to look at innovative technologies with regards to emissions reporting and management, building on the work done within our DPLA SIF project. As indicated within the GD specific questions in this SSMC response (GDQ3), if there is consideration of a UIOLI type of allowance to support these activities then this would reduce the need to have this as part of NIA.

OVQ48. Do you have any views on our proposal to retain a competitive network innovation funding pot, that continues to focus on key challenges facing the energy sector, with phases to de-risk the pot?

We agree with the proposal to have access to a larger competitive funding pot and the continuation of a similar mechanism to SIF. However, as per our response to the previous SIF consultation, thought needs to be considered around “proportionate” application and monitoring requirements versus the scale of the funding pot being applied for and subsequently managed. The move following that consultation was a positive one to allow access directly to Alpha and Beta phases providing that the “discovery” level activities could be demonstrated as completed through other routes. With that in mind, we would recommend the removal of the Discovery stage as it has the highest administrative burden relative to the value of any project. Any preliminary/feasibility/discovery level projects should be enabled to be delivered through a flexible allowance (NIA) or any other funding area that we have access to. The rationale for using NIA for this stage is that resource is required to support a competitive process, funding only starts once a project has been approved for funding, but a significant amount of time is spent to engage with the market, review pitching, filtering ideas, and working with innovators to develop the application.

As we are now discovering, the overall impact on resource of multiple rounds and the resource intensity required needs to be factored into our baseline resources to ensure we can continue to engage actively in SIF.

With regards to the current Alpha and Beta stages, the level of application required is broadly proportionate to the level of funding that is being applied for, however, we would recommend that consideration is given to enable a single application into Alpha with a decision stage-gate for access to the Beta phase. Having this option would have several benefits such as; i. ensuring there is no undue “gap” or “downtime” within a project, ii. project resources are focussed on any value adding stage-gate activities rather than applications, iii. 3rd party resources have greater security of continuation and less likely to look to other priorities.

With regards to the challenge areas that are reviewed and set on an annual basis, we would support more stability in this process to ensure continued alignment between rounds. Currently the 4 challenge areas are changed each round, we would recommend that at least 2 and ideally 3 of these challenges remain consistent for the full price control period with 1 flexible challenge that is reviewed each year.

OVQ49. Do you have any views on how the structure of the price control innovation funding could be adapted to better focus on whole systems problems, and ensure strategic alignment with other public sector initiatives?

Looking at the structure purely based on “whole systems,” there needs to be an effective way of moving or linking from one type of funding to another depending on the requirements, especially with regards to development work that is required by other bodies. For example, if a network company is carrying out work under NIA and other bodies are progressing development work that is required in line with the network activities then there needs to be flexibility to join/adapt future funding accordingly with being overly bureaucratic or administrative. Equally, a key enabler is to ensure the funding mechanism is flexible enough to deal effectively with changes in government direction or the work being progressed by the FSO.

OVQ50. Do you agree with our proposal to continue with a similar level of innovation funding, and if not, could you provide evidence for why a different amount is required, including consumer research you are aware of into their willingness to pay for network innovation?

Yes, we agree that a similar level of funding would be appropriate for RIIO3, uplifted in line with inflation and cognisant of increased supplier costs. Within the current NIA eligibility, we expect the volume and spend level of projects that relate to supporting customers in vulnerable situations to be consistent with that in RIIO2. This is a large area of focus with and having a similar level of funding would support the higher risk innovations, this then works well in conjunction with other funding mechanisms in this area such as VCMA and Welfare Provision.

With regards to Energy System Transition, as explained in our answer to Q5 of this SSMC response, there is a strong possibility that further evidence building work will be required at the start of the RIIO-3 period. This would also need to consider preparatory works for the first Hydrogen Towns. The continued provision of a flexible funding route is essential to ensure this work can continue at pace and continue without a hiatus between RIIO-2 and RIIO-3. A clear funding route whether that be NIA or UIOLI will also help ensure industry and supply chain interest is continually innovated and maintained, which is also critical to delivery at pace.

OVQ51. Do you agree there is a need to expand the scope of innovation funding to be more inclusive of third parties?

We feel that expanding the scope of innovation funding to be more inclusive to third parties is an area worth considering and should be allied with a review of whether greater flexibility is needed in the proportion of spend between the different parties for each mechanism to reflect where relative strengths lie. Taking NIA to begin with, it is worth noting that a minimum of 75% of any portfolio spend must be with third parties with any internal network spend being capped at 25% within each regulatory year, obviously this can vary by project. We feel that consideration could also be made to enabling us within the network to spend over this 25% cap especially for projects where we have the expertise and capability built internally to our business, e.g. IT, Data science and analytics.

A positive aspect of any expansion would be the potential for the de-risking of low TRL solutions, putting the onus on innovators to progress their own research and development and come with more “thought through” or mature solutions rather than just pitching an idea. There would need to be appropriate rigour applied to ensure that third parties were given access to funding that will support our priorities to avoid it being a negative aspect. Effectively we could become high level sponsors/advisors of projects initially with success opening opportunities for partnering arrangements – e.g. into NIA or even SIF Alpha depending on the project.

OVQ52. What are your views on us establishing an accelerator to support early-stage innovators?

Please see answer to OVQ51

OVQ53. What are your views on our proposal for this to be a smaller part of a future challenge fund and to be sponsored by networks?

Please see answer to OVQ51

OVQ54. Do you have evidence of potential innovation projects that have not been implemented or sought funding due to the five-year structure of the price control? How could this issue be addressed?

We do not have any specific projects that have not been implemented or sought funding because of the length of the price control period, therefore we do not have any actual evidence to draw upon.

There does need to be a consideration of how projects are transitioned between RIIO2 and RIIO3, we do expect to have projects in flight during the transition to avoid the “downtime” that we had at the start of RIIO2 because of the eligibility change. As an example, a project that is started in the last year of RIIO2 would be expected to continue into RIIO3, therefore we expect the need to have provision for Carryover NIA which may need to be in place for at least the first 2 years depending on the project complexity. If projects are likely to run longer into RIIO3 then these should be open to dealing with on a case-by-case basis agnostic of the funding mechanism that they sit within (NIA and SIF).

For SIF projects, there is an expectation that our current Beta project - DPLA - will complete in Feb 2026 so there would not be an issue with the innovation project itself but consideration for BAU implementation would be needed but has a level of uncertainty at this point, which is further outlined in another section of this SSMC response (GDQ3 & 4). Our current in-flight Alpha project - Digital Inspector - is expected to apply to the Beta phase. If successful, this could span the last year and half of RIIO2 and the first year of RIIO3 which as mentioned above would need case by case consideration of how it is transitions to ensure no pause or downtime within the project. The same challenges would need to be considered for any further SIF projects that are progressed through R3/4 discovery and subsequent Alpha/Beta phases.

OVQ55. Do you agree with our proposal to run FRS trials with an explicit focus on informing changes to the rules governing energy network activities – incentivised through SIF or other price control mechanisms?

Yes, we agree that running FRS trials in relation to NIA/SIF would be beneficial, likely to be more related to SIF than NIA, so it would be expected that any signposting of such projects would be identified through the regulatory barriers section of any SIF applications.

Please also refer to our wider response on the “Call for Input Proposal to introduce the Future Regulation Sandbox” which was sent to InnovationLink@ofgem.gov.uk on the 19th January.

OVQ56. What topics could FRS trials usefully focus on and why?

For innovation projects, the one project area that we have identified as a focus would be the SIF DPLA project. Please refer to item 2 in the Potential Application section of the above-mentioned call for input response, text below for reference.

“The trialling of changes to distribution networks Shrinkage and Leakage Model (Special Condition 4.4) to permit learning and outputs from the Digital Platform for Leakage Analytics (DPLA) innovation project to be tested prior to any enduring change. The reporting of shrinkage has important impacts on the identification of networks’ emissions and on consumers bills; the ability to trial updates to the Shrinkage and Leakage Model driven by the DPLA project prior to permanent change could help change future price control incentives as discussed in our response to Q21.

OVQ57. Do you have any feedback on the view that not enough network innovation funded projects have been rolled out, and can you share any evidence you have to support your position?

Innovation projects by their nature are not linear so having a specific roll out mechanism could be considered but only if the accessibility were not overly onerous to access and gain approval for.

Many innovation projects are purely for research and learning generation which enables and encourages iterative development to ensure the right ideas are refined as they are taken forward or not as required. We should not be afraid to admit that a negative finding/learning from an innovation project does not necessarily mean an unsuccessful project outcome. Therefore, not all projects need to be physically rolled-out but the focus is on documenting (production of white papers etc) and disseminating the learning accordingly. In addition, there could also be a lag between an innovation project closing and the solution being implemented into the business, we are bound by safety case requirements and complex procurement regulations that can and will cause roll out related challenges, especially for significant IT investments. As such, specific tangible benefits are often unlikely to be realised in the same price control period.

Rewards for the roll-out of NIA projects and a roll-out allowance for SIF projects could help incentivise deployment and remove barriers to getting larger, cross-sector/licensee IT investments underway, subject always to relevant legislative, policy or regulatory requirements.

OVQ58. What are your views on the design of potential new mechanisms to address this?

We would support the potential of a new mechanism to support roll out related activities but as mentioned in the response to OVQ57, innovation projects are not linear, and any mechanism needs to be flexible to account for different types of project outcomes. We support full consultation on this as any new mechanisms would have to work well/compliment the current NIA/SIF type arrangements.

As an example, deployment plans and rollout to BAU is a significant key deliverable within our SIF DPLA Beta project and as such is firmly part of this wider SSMC response with regards to the impact on leakage/shrinkage. Within that project, our considerations and proposal for a “roll out” equivalent would be a UIOLI approach with the appropriate evidence requirements. This approach could set a precedent for future projects of this scale and nature.

For smaller scale innovation projects, consideration could be given to including an additional aspect within the NIA and SIF type mechanisms and associated eligibility requirements. It would not be expected that all of the roll-out costs would be suitable to be funded, but potentially say 20-50% of the costs of roll-out dependence on cost benefit analysis and cost savings. This could be in the form of a time bound stage-gate at the end of the innovation project to enable more rapid implementation – e.g. the roll out funding is available for the first 6 months following innovation project completion but then removed if the timescales are not met.

The graphic below (figure OVQ58.1) is a draft example of how the funding structure for innovation could work overall, this is work that has been drafted by the gas network licensees through the Gas Innovation Governance Group (GIGG) so other networks may have included similar in their SSMC responses. It has been shared with Ofgem (Luke Ames Blackaby) through GIGG to build awareness that this is something we have been working on collaboratively.

RIIO-3 Ofgem Innovation Mechanism

Proposed Innovation mechanism for RIIO-3

Network Innovation Incentive (NII)	Research & Development	Baseline Innovation Fund for each network (90% funded) Projects <£1.5m	NIA	Budget for the RIIO-3 period to be managed by the network to develop projects, stakeholder collaboration	TRL 1-6
	Innovator Accelerator	Innovation Fund for Innovators supported by networks (TBC%)	*new	Ability for innovator led activities to be funded, supported by networks but not led	TRL 4-7
	Demonstration	Innovation Fund for Projects >£1.5m, requiring approval and peer review. (up to 90% Funding). Assessment made by 3 rd party to ensure consistent approach and meets energy system needs.	SIF	Request for funding window open every 6 months Submission must include evidence of past (NIA) work proving demonstration capability and all key elements as seen today in SIF process. Could be managed through UKRI or other system. Option to start with short Alpha phase or move straight to Beta	TRL 4-8
	Future Regulator Sandbox	Funded through NIA/SIF or Reopener activity	*new	Ability for networks to trial innovative approaches to the energy system in live trials led by Ofgem. Sits alongside the current regulatory sandbox.	TRL 7-9
	Scale Up & Hand Over	Baseline Innovation Fund for each network (up to 90% funded) Projects <£1.5m	*new	Budget for the RIIO-3 period to be managed by the network to disseminate projects, deliver benefits across energy system and implement	TRL 7-9
	UM Development	UIOLI Fund for each network to enable development of Net Zero Projects <£2m (100% funded)	UIOLI	Budget for the RIIO-3 period to be managed by the network to develop Net Zero Solutions for reopener application	TRL 7-9
	NZ UM	Opportunity for networks to attain additional funding for hydrogen and net zero projects CAPEX (100% funded)	UM	Budget for the RIIO-3 period to be managed by the network to deliver Net Zero Solutions into the network	TRL 7-9
	Implementation	Business Funded deployment activities (0% funding)	BAU	Business to self fund implementation past the first deployment and ensure driven into relevant investment programmes	TRL 9

Figure OVQ58.1: Gas Innovation Governance Group draft example of how an innovation funding structure could work

Data and digitalisation

Key Message:

In principle we support the desire to modernise regulatory reporting, but this should be developed in alignment with the objectives of the wider Virtual Energy System (VES) programme so that it can support the needs of the common data sharing infrastructure as we transition to net zero. The timetable shown (to April 2026) may be challenging to meet based on our experience of similar projects and the inherent complexity. As such the proposed timeline needs extending so that rich discussions can take place across the energy sectors to crystallise the full scope of the reporting, so that it is fit for purpose and can be introduced in a cost-effective way which avoids excessive costs and adds value for consumers. Our proposal is that the modernisation should start in April 2026 rather than be implemented from 2026. The re-purposing of the non-operational IT capex re-opener for digitalisation is sound as the current uncertainty around timeline, scope and requirements make it impossible to reliably forecast costs in this area. As outlined below such a re-opener would also provide the time and flexibility Ofgem and the industry need to start to deliver the overall Virtual Energy System programme of work.

In terms of modernising regulatory reporting RIIO-GD3, we support the intent as this presents an excellent opportunity to remove those reports that do not add value or where data is duplicated across reports. In our response below we suggest that this review should also seek to challenge the granularity of certain reports and explore opportunities for automation as this will facilitate reduced regulatory burden for both Ofgem and networks and that focus is placed in the areas of most importance

OVQ59. Do you have any views on the timelines for modernising regulatory reporting?

We support the desire to modernise regulatory reporting as this should lead to simplification and ease of reporting and ultimately a reduction in regulatory burden for both Ofgem and network companies. However, we think **the proposed timeline is too ambitious** based on our experience of similar projects and the inherent complexity.

We have three key concerns with the timeline presented by Ofgem.

- **First, it should start with and allow sufficient time to define the scope of the project.** This is crucial to ensure that any subsequent work is fit for purpose and delivers the intended outcome. We welcome and share the view from Ofgem that modernisation of the RRP submission is not only a technology project, but also involves cultural change and investment in data literacy both within Ofgem and networks. Therefore, we would suggest Ofgem starts with an initial mobilisation phase which will define the scope of the project. The scope should be defined based on value and ease of use for Ofgem, network companies, customers and energy consumers. We also believe that any upcoming consultation on the scope should include all types of network companies (i.e., including DNOs), and that the scope should be consistent across all companies. The scope should be pragmatic and consider the following points:
 - Prioritisation of those reports that have **universal value** across multiple use cases (most probably asset and operations), provide insight into Great Britain's **Net Zero/whole system approach and provides Consumer value**. The initial scope should not be more than a handful of reports, with a back log that iteratively grows the report sets. RIIO3 should be focussed on achieving these priorities.
 - The scale of work required to review the outputs reports we produce and the

underpinning processes should not be under-estimated. In essence as we automate the reports, the upstream processes generating and assuring the data will also need to be digitised. Complex reports can take a year to eighteen months to transform.

- There should also be a recognition about new roles RRP transformation may trigger. For example, governance arrangements to ensure that the data is transferred correctly as it will be difficult for licencees to provide assurance of this process.
- **Second, the timeline is too tight at the end of the process. It will not leave sufficient time to enable the RRP modernisation to start in RIIO3.** It appears that Ofgem will be making decisions about their own internal data infrastructure in Q1/2 of 2024, with Q3/4 being used to develop the high-level scope. If the intent is to complete the consultation process in 2025, **we do not think that this will leave sufficient time to enable the RRP modernisation to start in 2026 as it only allows six months for licencees to implement the regulatory reporting in a form that is usable.** This needs to be balanced with the time required to scope, design and build the necessary processes, digital products that would collect, prepare, calculate and assure the appropriate data. This timeline is likely to differ for each of the licencees as it will be dependent on the number and capabilities of the current solutions used for regulatory reporting. In addition, decisions will need to be made based on gap analysis of the most efficient solution design that addresses the requirements of the modernisation.
- **Third, the timeline proposed in Q3/Q4 2024 coincides with the timelines for the submission of GDNs' business plans.** This will inevitably constrain the availability of the relevant subject matter experts for the planned discussions.

As a result of this, we do not think it is realistic to implement the outputs of the modernisation programme in time for the start of RIIO-GD3 as the modernisation should be seen as a use case in the wider Virtual Energy System (VES) programme as described in the Working Group on 22nd February, rather than in isolation. This would ensure that the networks focus on the investments that are strictly aligned to a strategic vision with Ofgem being one of the “data actors” in the wider system, without this joined up with there is a risk that two separate investments will be required for the preparation of the data for the RRP modernisation and preparation of the data for VES, leading to unnecessary costs being incurred.

Therefore, we think it is more realistic to initiate modernisation in 2026 to allow for sufficient discovery and scoping of requirements as there is a need to also, align with the wider energy sector, and agree aspects of governance, inter-operability and assurance which should all be decided as part of a set of **workshops on scope and definitions**, and include:

- data semantics and terminology, data models, metadata and supporting information including expectations on quality and limitations,
- the governance and assurance options for modernised regulatory reporting especially for the areas where not all data is available as point in time information.

We suggest an alternative timeline could be:

- Scope development - Q1 2025
- Consultation to develop objectives, requirements and associated programme of work for each licensee - Q2/Q3 2025.
- Agreed project plan - Q4 2025
- Modernisation initiation - 2026

This timeline would require the introduction of a re-opener to allow GDNs to recover the costs associated with the programme. We welcome Ofgem's proposal, set out on page 94 of the SSMC Overview document, to retain an Uncertainty Mechanism for the non-operational IT capex re-opener

and evolve this for digitalisation, as the uncertainty around timeline, scope and requirements make it impossible to reliably forecast our costs in this area. Such a re-opener would also provide the time and flexibility Ofgem and the industry need to start to deliver the overall Virtual Energy System programme of work.

OVQ60. Do you have any initial views on opportunities for improving efficiency in providing the data that Ofgem receives as part of regulatory instructions and guidance?

We agree that improving efficiency in the implementation of the regulatory instructions and guidance should be a priority for both Ofgem and companies. We make the following suggestions:

- **Removing those reports that do not add value or are duplicated across reports.** Examples include business carbon footprint which is reported in the RRP tables as well as in the AER, Repair Risk – which is not an output in RIIO-2, planned interruptions the targets of which were removed for RIIO-GD2, and our annual report on Community Funding which includes data we also report in the annual RRP;
- **Reviewing and challenging the granularity of certain reports.** Examples include:
 - Smart metering - We understand the requirement for data to be reported to feed into the cost assessment. However, given the stage of the programme we do not think the level of granularity is still required.
 - Water ingress data - Water ingress data was reported on one table in RIIO-GD1 but is reported across three separate data tables for RIIO-GD2.
- **Exploring opportunities for automation.** The automation of price base conversions would alleviate significant regulatory burden since most systems capture costs in “today’s money”. It should also be borne in mind that any automation is likely to mean that the existing role and governance models also need to change, for example how formula changes and updates to templates would be controlled; and
- If the ambition is to modernise reporting requirements and processes in both gas and electricity, Ofgem should make sure it captures and reflects the requirements and needs of other sectors as part of this programme of work to ensure that the output is helpful and relevant to other sectors.

This response should be read in conjunction with our response to GDQ66.

OVQ61. Are there areas of regulatory reporting that would be most beneficial to start with in the modernising project?

We would suggest the following priorities for the modernising project:

- **Ensuring consistency in reporting across all network companies.** This is essential to support accurate comparisons of data and we have highlighted examples of inconsistencies in current reporting in our response to GDQ65. We appreciate that this is being discussed as part of CAWG and BPDT working groups.
- **Automating price conversion.** The conversion of costs into a specific price base creates a very significant burden for companies. This has effectively doubled the data assurance we are required to carry out for each submission. We consider automating this operation is a “low hanging fruit” that would tackle a source of high regulatory burden.
- **Removing duplication and streamlining requirements.** As set out in our response to OVQ60, there is an opportunity to review the overall content of the reports to remove unnecessary duplication and granularity so that the volume of data is proportionate and adds value for customers. We appreciate that the current reporting is discussed as part of annual RIGs consultations but this approach should be adopted as a principle more generally.