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Dear Akshay,

Response to RIIO-3 Sector Specific Methodology Consultation

Thank you for the opportunity to respond to the above consultation. This response is on behalf of UK Power Networks' three distribution licence holding companies: Eastern Power Networks plc, London Power Networks plc, and South Eastern Power Networks plc.

The current Revenue = Incentives Innovation and Outputs (RIIO) framework has proven to be an incredibly effective regulatory regime that has underpinned investment and significant reliability and service improvements in the energy sector. The fact that the only utility company in the 2023 Institute of Customer Service's top 20 organisations was a Distribution Network Operator is testament to this; the GB RIIO framework is rightly held as an international benchmark for what good regulation looks like.

Good regulation adapts for good reasons, and Ofgem has a proven track record of evolving regulations for the benefit of consumers; RIIO-ED1 introduced strong incentives for companies to earn additional returns over the allowed cost of equity based on delivering operational excellence – improved reliability, better customer service and engagement – rather than through financial engineering. Similarly, RIIO-ED2 made adaptive regulation a reality, introducing uncertainty mechanisms to unlock investment given the uncertainty on the timing, location and extent of investment required to facilitate low carbon technologies. RIIO-ED2 has evolved by eliminating some of the issues identified in RIIO-ED1.

We encourage Ofgem to look at the RIIO-3 process as an opportunity to build on the success of previous price controls. This means keeping those elements which have been working well and focusing changes only in areas where more can be done to promote investment in the right place at the right time, deliver better service to customers and respond to external changes in policy and consumer behaviour.

In Table 1 below, we have summarised our current thinking across the suite of areas in your Overview and Finance consultation documents, which we believe will help to set the energy networks sector up for continued success.

Key factors	UK Power Networks' response
Investability and the cost of equity	<ul style="list-style-type: none"> • It is generally acknowledged that the level of investment in electricity networks will need to increase over the next decade to support the delivery of the 2050 Net Zero target. • The UK energy networks sector will need to compete globally for capital given that Net Zero investment is increasing worldwide. • The cost of equity, which is the incentive to invest, must be set at a level that will both retain and attract the necessary levels of equity. • We are very concerned with Ofgem's "through the cycle" approach to the cost of equity as we believe it may damage the incentive to invest at a crucial period of global competition for investment. • There must also be a suitable differential between the allowed cost of debt and the allowed cost to equity to appropriately recognise the risk equity investors take.
Inflation indexation	<ul style="list-style-type: none"> • GB's real rate of return regulatory framework is regarded as one of, if not the best, in the world and inflation protection is a core component of the framework. • We remain of the view that unless Ofgem can demonstrate that any of the proposed alternative approaches to inflation indexation are better than no change, then the existing approach adopted for RIIO-ED2 should be maintained. • It is not in customers' interests if changes to the framework reduces the credit rating agencies' and investors' assessment of the stability and predictability of the GB regulatory regime. • It is also unclear why breakeven inflation would be a better long run inflation assumption than the current approach of using the OBR forecast. • If Ofgem can robustly demonstrate that altering the RIIO-2 inflation indexation approach is in customers' interests and causes no rating agency issues, then we believe that Option 1 would be the preferable option.
Future of Gas	<ul style="list-style-type: none"> • We agree with your view that use of multiple FES scenarios is an appropriate way to better understand the impact of uncertainty around the pace of reduced demand for gas.
Role of Scenarios and Planning Pathways	<ul style="list-style-type: none"> • We believe Ofgem should set baseline allowances based on the lowest Net Zero compliant scenario for each sector using uncertainty mechanisms to adjust these allowances to meet the scenario that emerges within the price control period. • To calibrate the uncertainty mechanisms and explore the range of investment that may be required in the period, all four FES scenarios should be costed in the respective RIIO-3 business plans similar to what UK Power Networks did for RIIO-ED2.

Key factors	UK Power Networks' response
Outputs and Incentives	<ul style="list-style-type: none"> • Incentives are the most important part of the RIIO framework as demonstrated by the performance improvements seen in the RIIO-ED1 period. • Ofgem should make clear what it deems as "good" performance for RIIO-3 taking into consideration new or changing customer expectations. The RIIO-3 suite of incentives should reflect this. • Ofgem should consider how the targets that it sets are stretching but achievable, avoiding ludicrous situations such as LPN needing to deliver negative CI/CML to realise full reward in the IIS. • Targets should be set up front and given the shorter price controls, updated at subsequent reviews. This avoids the issues we are currently experiencing in RIIO-ED2 with several licensees still not able to measure DSO metrics a year into the new price control. • The use of deadbands should be avoided wherever possible to ensure incentive properties are retained and avoid distortions. • We believe reputational incentives are unnecessary and add complexity to the regulatory framework for little benefit to consumers. Ofgem should focus on a small number of high-powered incentives aligned to customer needs and drive network companies to deliver these. • The hurdle for bespoke incentives should remain high, however innovative thinking and differing customer requirements should not be penalised.
Truth Telling and Efficiency Incentives	<ul style="list-style-type: none"> • We agree that the objectives of the truth telling incentive should be to support: <ul style="list-style-type: none"> ◦ Business Plan information that enables Ofgem to set the price control effectively; ◦ Provision of ambitious cost forecasts; and ◦ Provision of ambitious output proposals that go beyond baseline expectations. • The two levers used in RIIO-2, BPI reward and sharing factor did not suitably distinguish between companies that strived for the above and those that did not. RIIO-3 should address this to deliver meaningful rewards and/or penalties. • To provide the clarity required for a meaningful incentive, the assessment of Business Plans should be based on a set of objective criteria established and published before Business Plans are produced and submitted.
Managing Uncertainty	<ul style="list-style-type: none"> • Uncertainty mechanisms are an essential tool in the price control to manage uncertain demand and unlock additional investment as demand materialises, and policy certainty is achieved. • To ensure effectiveness and pace of adaptation, the suite of uncertainty mechanisms should be kept to a minimum and targeted in the areas of greatest uncertainty. • Uncertainty mechanisms must be calibrated appropriately linking to FES scenarios and reflect the full cost of delivery e.g. adjust for indirect costs too.
Cost of Service	<ul style="list-style-type: none"> • We support indexation of RPEs and believe indexation should also be extended to Ongoing Efficiency; this will provide a more transparent and robust basis rather than an arbitrary 1% per annum.

Key factors	UK Power Networks' response
Cyber Security	<ul style="list-style-type: none"> We are fully supportive of the continued focus on cyber security. Ofgem should provide ex-ante funding linked to cyber security and measure licensees' achievement of the "Enhanced Profile" under the Cyber Assessment Framework for this investment.
Innovation	<ul style="list-style-type: none"> We agree that innovation will be central to delivering the energy transition at lowest cost with the service our customers expect of us. We believe that if incentives are set correctly, companies will naturally innovate to deliver efficiently and improve service to customers – potentially negating the need for ongoing separate innovation funding.
Data and digitalisation	<ul style="list-style-type: none"> We are supportive of steps to improve the efficiency of data transfers between licensees and Ofgem. New arrangements should continue to facilitate licensees' abilities to assure their submissions.

Table 1 – Key factors for RIIO-3 and UKPN's response

We provide further explanations below together with more detailed answers in Appendix 1.

Investability and the cost of cost of equity

It is generally acknowledged that the level of investment in electricity networks will need to increase to support the delivery of the 2050 Net Zero target. The GB energy networks sector also needs to compete globally for capital given that Net Zero investment is increasing worldwide. Consequently, we are pleased that Ofgem recognised that investability (i.e. the attractiveness of the energy sector to equity investors) is a key consideration for RIIO-3.

The cost of equity, which is the incentive to invest, must be set at a level that will both retain and attract the necessary levels of equity. With regard to the latter, we are very concerned with Ofgem's "through the cycle" approach to the cost of equity. The implication of this approach is that a cost of equity could be set for RIIO-3 below the required level. The rationale for this is that it may have been set higher than required in the past or would be set higher than required in the future. We believe that such an approach damages the incentive to invest. Furthermore, it must also be recognised that the macro-economic environment, particularly with respect to interest rates, is very different to when the cost of equity was set for RIIO-2. It is vital that there is a sensible differential between the RIIO-3 allowed cost of equity and the RIIO-3 allowed cost of debt to reflect the risk that equity investors are taking.

In summary, if the cost of equity is set too low for RIIO-3 then the sector may not be able to attract the required levels of equity. This would mean that either debt levels would need to increase to fund the required levels of investment, impacting on financial resilience, or the rate of investment would be below the required level, acting as a brake on facilitating Net Zero. Neither outcome would be in customers' interests.



Inflation indexation

The GB regulatory framework is regarded as one of, if not the best, in the world and inflation protection is a core component of the framework. We believe there should be a high bar to change the existing framework. The continued stability and transparency of the GB energy regulatory framework will be essential if we are to attract the necessary capital, from a global market, to meet the increasing investment requirements.

In our response to the Call for Input, we stated that our preferred option was for no change to the approach to inflation indexation unless Ofgem could demonstrate that it was in customers' interests to do so. We remain of that view. We are concerned that Ofgem has ruled out the no change option without robustly demonstrating that any of the alternatives that it has proposed are better for customers. Altering the approach to inflation indexation would be a fundamental change to the real rate of return regulatory framework. It would not be in customers' interests if any change to the framework reduces the credit rating agencies' assessment of the stability and predictability of it. If this were to occur it would raise borrowing costs for companies and hence ultimately costs to customers.

If Ofgem can robustly demonstrate that altering RIIO-2 inflation indexation approach is in customers' interest and causes no rating agency issues, then we believe that Option 1 would be the preferable option. This option better aligns actual interest costs with the associated revenue recovery. Hence, it is not pushing more costs onto future customers and consequently may be better in terms of inter-generational equity. Given that inflation impacts a number of areas of the price control it will be essential to ensure that if either Option 1 or Option 2 are implemented there are no unintended consequences in other elements of the price control framework.

It is also unclear why breakeven inflation would be a better long run inflation assumption than the current approach of using the OBR forecast. Breakeven inflation is derived from the market price differential between a nominal government bond and an RPI-linked government bond. There are a range of factors that may affect bond pricing including: inflation risk premium, liquidity premium, potential additional convenience premium brought by index linked gilt (ILG) over nominal gilt, and supply and demand dynamics in general which are unrelated to inflation expectations. The only relevant part of this differential is the inflation expectation, and it will be difficult to disentangle this element alone. If Ofgem can demonstrate that it should move from the OBR inflation forecast, then it is essential that it considers all credible options and not just breakeven inflation.

Future of gas

We recognise the impact of wider policy decisions on gas will be significant across all sectors. Therefore, appropriate use of future scenarios to inform baseline funding and the use of uncertainty mechanisms will require focus and understanding across sectors to ensure the framework supports the most efficient whole-system outcomes for current and, importantly, future customers. We outline how future scenarios should be used below.

Role of Scenarios and Planning Pathways

We support the continued use of the Future Energy Scenarios (FES) framework when selecting RIIO-3 scenarios. Learning from RIIO-2 and recognising the uncertainty of the pace of transition to low carbon technologies, we believe it is important that Ofgem sets baseline allowances on the lowest Net Zero compliant scenario for each sector. A set of simplified uncertainty mechanisms can then be used to unlock the further funding required to match the pace of our customers' demands.



In addition to this, we advocate for the use of the full suite of FES scenarios as a sensitivity test for all RIIO-3 business plans. All network companies should be obliged to forecast expenditure in all four FES scenarios and this would be equivalent to the approach set out by Ofgem for RIIO-ED1. This would provide Ofgem with a full suite of information, helping minimise information asymmetry and enabling appropriate calibration of uncertainty mechanisms across sectors. Whilst we recognise that *"Falling Short"* is not Net Zero compliant, we believe all networks should provide a forecast of expenditure aligned to it, as it is a plausible view on what could outturn over the RIIO-3 period.

We agree with Ofgem that using FES 2023 as a basis for planning risks using significantly outdated data by the time RIIO-3 commences. Nevertheless, we would welcome the opportunity to further discuss the potential requirement to move to the latest FES forecasts for the Final Business Plan submission ahead of locking in equivalent timeframes and requirements for RIIO-ED3.

Outputs and Incentives

Powerful incentives are a hallmark of the GB regulatory framework. RIIO-ED1 was a clear example of incentives driving performance improvements and RIIO-3 is an opportunity for an evolution of the framework to replicate that success by setting stretching yet achievable targets.

We encourage the use of static targets where possible. Static targets provide companies the certainty required to build business cases for service improvements and investments that deliver for customers. Targets should be set based on the average past performance and not penalise those that set the frontier as was the case for LPN in RIIO-ED2, where it would have to deliver the impossible (i.e. negative CI or CML) to realise the full reward under the IIS incentive.

We discourage the use of deadbands as they have the potential to lose effectiveness in the deadband area. For example, a company operating in the deadband with a large gap to either reward or penalty does not face an immediate incentive to improve performance levels. A continuous incentive band avoids this issue and can also help avoid incentive rates that are overly sensitive by allowing a broader spread of performance to be incentivised.

We are concerned that the dampening of incentives in RIIO-2 will deliver smaller improvements in the services that matter most to customers. RIIO-3 is an opportunity to rectify this issue.

Truth Telling and Efficiency Incentives

A clear and well set out set of assessment criteria, with appropriate rewards and penalties laid out in advance would be a major advance for RIIO-3. Ambition, innovation and efficiency could be effectively rewarded provided the rules are clear and transparently communicated ahead of Business Plan submissions.

Ofgem must ensure that the two key levers of the BPI reward and sharing factor distinguish between companies that strive to produce efficient and ambitious plans and those that do not. We believe this was not the case in RIIO-ED2 where the sharing factors were effectively equivalent for the best and average companies; this should be addressed in RIIO-3.



Managing Uncertainty

We support the retention of uncertainty mechanisms in the regulatory framework, particularly volume drivers for high volume, lower value activities such as distribution assets at the lower voltages. We consider that monitoring of uncertainty mechanisms should follow on from how these mechanisms were treated in RIIO-ED2. Where possible, uncertainty mechanisms should operate automatically and reflect the full efficient cost of delivery including indirect costs.

Cost of Service

We advocate for evolution of Real Price Effects (RPEs) for RIIO-3 in the following ways:

- Application of RPEs to all costs as Ongoing Efficiency is applied to all costs, noting that RPEs were only applied to a portion of costs in RIIO-2.
- Exploring the potential to index Ongoing Efficiency in a similar manner to the approach adapted for RPEs in RIIO-2.
- Review of RPE indexation to ensure that current indices are appropriately capturing cost pressures experienced by network companies.

Cyber Security

We agree with Ofgem that cyber resilience and security is an increasingly important topic for network companies and one which warrants continued focus in the regulatory framework. Given that the RIIO-3 framework spans the period by which all companies must achieve the “*Enhanced Profile*” against the Cyber Assessment Framework (no later than the end of 2027), Ofgem should allow ex-ante cyber funding to companies and hold them to account for delivering the “*Enhanced Profile*” outcome, similar to how the Health Index is used to measure the output of network investment.

Innovation

Innovation is an essential part of delivering the investment that will be required to facilitate the energy transition at lowest cost while maintaining the high standard of service our customers expect of us.

If Ofgem can create the right incentives similar to a competitive market, companies will naturally innovate to deliver efficiently and improve service to customers – potentially negating the need for ongoing separate innovation funding.

We recognise Ofgem’s desire for more funding to be available to third parties to develop innovative technologies and ways of working. We believe network companies will respond to incentives and work with the best providers to innovate and adopt successful products and services while maintaining a focus on the improvements most valuable to customers.

Data and digitalisation

We welcome a review of where improvements can be made to regulatory reporting including the modernisation of how data is reported to the regulator to reflect the digital age that we live in. However, any changes should not undermine the important principles that underpin the current reporting framework such as:

- Appropriate assurance ahead of submission.
- Transparency of data and sources.
- Certainty of data capture requirements.



With the above in mind, we encourage Ofgem to ensure any changes in reporting requirements are signalled and implemented as far in advance as possible to allow companies to establish processes to collect the data accurately with appropriate funding to deliver new requirements.

As we say, good regulation adapts for good reasons and Ofgem has a strong track record of delivering an internationally praised regulatory framework. RIIO-3 should build on the success of previous price controls which have been working well and focus changes only in areas where there is good evidence of changes being required.

We hope that you will find our comments helpful and if you wish to discuss any part of our response, please do not hesitate to contact us. We look forward to working with you over the coming months to develop the suggestions in this response, both for RIIO-3 and importantly RIIO-ED3.

Yours sincerely,



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