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Canary Wharf  
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E14 4PU

(to Steve McMahon, Price Controls Director by email, copied to RIIO3@ofgem.gov.uk)

06 March 2024

Dear Steve,

### **SP Transmission (SPT): RIIO-3 Sector Specific Methodology Consultation (SSMC) Responses**

The effective and efficient delivery of unprecedented transmission investment at pace during RIIO-T3 will be critical to support Government priorities including Net Zero targets and unlocking social and economic benefits whilst enhancing GB energy security. The Net Zero transformation and energy security are key to growing the UK economy. We welcome Ofgem having regard to promoting sustainable economic growth, through the newly proposed Growth Duty. To deliver these priorities the RIIO-T3 regulatory funding framework must promote the necessary investment whilst balancing the appropriate flexibility to manage uncertainty.

SPT's aim through this response and its wider RIIO-3 engagement is to support Ofgem's establishment of a methodology that is a catalyst to the delivery of these priorities.

**The RIIO-T3 period presents a wholesale change in the balance of risk and reward for all stakeholders** – the legally mandated Net Zero targets set a clear goal where the benefit of delivering this objective impacts every sector of society, consequently the risk of not achieving these targets cannot be overstated. Further, this critical investment would unleash meaningful and far reaching direct and indirect economic benefits to individuals, communities, and the country, in tandem with Net Zero – whilst also helping to alleviate the forecast of up to £2.5bn/year<sup>1</sup> in constraint costs <sup>2</sup>to customers by facilitating the transport of increasing renewable generation to people's homes and businesses.

**The RIIO-T3 period represents a significant step change from historic risk environment – both in terms of our CAPEX and scale and complexity of operations.** The RIIO-T3 period will require SPT to invest on an unprecedented scale (at more than double RIIO-T2 investment levels, and six times RIIO-T1) whilst, it is highly likely, the revenues we earn will not be sufficient to fund this expenditure. To fund this forecast c.£7bn of investment, based on RIIO-T2 assumptions, we would require c.£2bn of new equity and to raise c.£3bn of debt.

**It is imperative the price control offers returns that will compete with other international opportunities for global investors and that Ofgem ensures that TOs remain investable during RIIO-T3 after consideration of all probable risk.** SPT require the RIIO-T3 price control arrangements to promote an inflow of funds in the form of fresh equity and debt finance from investors. Ofgem needs to balance this risk in the context of forecast future business and market conditions. This will be imperative to achieving the governments Net Zero commitments and Ofgem's new growth duty.

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<sup>1</sup> NOA 2020/21 - Modelled Constraint Costs, available at <https://www.nationalgrideso.com/document/194436/download>

**We do not believe Ofgem should change the current approach to inflation as an instinctive reaction to an extreme inflation event.** Our preferred option is to maintain the current approach which is well understood by investors and a core tenet of GB regulation.

**We urge Ofgem to ensure timely delivery incentives are targeted on major strategic projects only and calibrated to ensure ongoing financeability and investability of TOs** (Transmission Owner). We recognise that delivery incentives for major projects have a role to play in the regulatory framework. However, to date, no financeability nor investability assessment has been completed for the ASTI ODI, which potentially includes very significant penalties across the set of ASTI projects. The calibration of delivery incentives should be centred around appropriate dates thus ensuring incentives and penalties are fairly distributed. A key weakness of the current ASTI Output Delivery Incentive (ODI) framework is the target delivery and ODI Neutral dates are set, based on earliest-in-service dates (EISDs). EISD dates are highly ambitious and were identified as theoretical 'earliest' possible delivery dates through the NOA and HND process and were never intended to be used to set regulatory frameworks. Therefore, the probability of timely delivery for these projects is significantly below 50%.

**RIO-T3 benchmarking, totex incentive sharing factors, revenue drivers, and re-openers need to recognise the extent of delivery and cost challenges that are outside the TOs' control.** Upward price pressures in RIO-T2 from global supply chain constraints, global decarbonisation targets, and economic growth are far exceeding the risk mitigation provided by the RIO-T2 RPE mechanism and CPI indexation. During RIO-T2 TOs have seen unprecedented increases in prices and lead times of plant, equipment and civil infrastructure.

**RIO-T3's cost assessment should focus on engineering review of need case and optioneering to ensure that licensees proposed investments are developed to a level of maturity and presented with sufficient transparency.** The RIO-T2 Project Assessment Model (PAM) is not a suitable starting point for RIO-T3 cost assessment. The RIO-T2 process was not a robust methodology for providing efficient allowances. Also recent extreme price volatility will have a significant impact on the validity of historical costs as benchmarks.

**RIO-T3 needs to provide greater regulatory certainty and access to pre contract funding.** To deliver the scale of investment it is critical the supply chain, which supports UK Transmission Owner activity, has the confidence to expand. We strongly support Ofgem's position that Pre-Construction Funding (PCF) and Early Construction Funding (ECF) are essential to enable the TOs to have finances readily available to progress major projects from an earlier stage. We welcome Ofgem's commitment to provide TOs with PCF and ECF following the Centralised Strategic Network Plan (CSNP) to enable the timely progress on new transmission projects.

**To support the works that will be critical to enabling CSNP projects, PCF and ECF should also apply to non-CSNP re-openers.** This would further support a programmatic approach to procurement allowing TOs to secure the relevant manufacturing and supply chain on a bulk basis, resulting in a more efficient deployment of resources and enhancing long term customer value.

**Challenges with the GB transmission connections queue require bold and radical reform alongside RIO-T3 if the electricity industry is to be enabled to successfully support Government targets.** With a current GB generation and storage connections queue rapidly approaching 700GW, c.7 times that forecast to be required in 2050 in the ESO FES, and volumes of new applications continuing at an all-time high (108GW across GB in Dec 2023 alone), it is essential that connections reform and proposed Strategic Spatial Energy Plans enable TOs to progress customer contracts and network investment on the basis of credible, viable and necessary connections. In 2023 SPT processed c.800 in area connections applications for >38GW. This represented an 80% increase on 2022 volumes and a 300% increase on 2018 volumes, contributing to an SPT queue >50GW. The ESO currently forecasts that <20% of these contracted connections will connect to the network. This unprecedented connections activity and associated output delivery incentives (ODI) must be considered in conjunction with major projects to ensure that the system is developed in a coordinated way.

We would encourage Ofgem to consider the UK's Electricity Networks Commissioner's, Nick Winser, recommendations<sup>3</sup> throughout the RIIO-T3 planning and decision-making process. The SSMC omitted questions on these points, including the need for urgent planning reform, and the social and economic value that critical infrastructure projects will bring to society across GB. A key component of the price control framework should be to further support the objective of accelerating transmission infrastructure delivery.

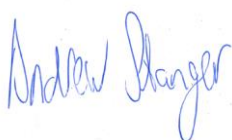
Finally, we wish to emphasise Ofgem should accept further written feedback in the coming months as policy areas progress - working groups are scheduled post the closure of this consultation and will continue to explore many RIIO-T3 policy areas which have not yet been determined. We welcome this opportunity to respond with constructive feedback, and the proactive and collaborative engagement between Ofgem and the TOs evidenced to date through the RIIO-3 Working Groups. We are committed to ongoing engagement with Ofgem.

### Next Steps

We look forward to attending and contributing to the remaining cross sector and ET working groups and welcome focused bi-lateral and broader engagement on the issues set out in this letter.

Should you wish to discuss any of the matters that we have raised in this letter and our detailed response to the consultation questions, please do not hesitate to contact me.

Yours sincerely,



**Andrew Stanger**

RIIO-T3 Programme Director

### Attachments:

Appendix 1 below sets out our views on key themes across the suite of Ofgem SSMC annexes

- SPT response to the RIIO-3 SSMC Overview Document
- SPT response to the RIIO-3 SSMC Electricity Transmission (ET) annex
- SPT response to the RIIO-3 Financial Annex and supplementary financial evidence

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<sup>3</sup> [Accelerating electricity transmission network deployment: Electricity Networks Commissioner's recommendations](https://www.gov.uk/government/consultations/accelerating-electricity-transmission-network-deployment) - GOV.UK ([www.gov.uk](https://www.gov.uk))

## Appendix 1 – Summary of SPT views on key SSMC themes

### 1. Process

- *Challenging timescales leave no room for Ofgem delay or error and compromise stakeholder influence*

### 2. Cost Assessment

- *RIO-T3's cost assessment should focus on engineering review of need case and optioneering. Recent extreme price volatility will have a significant impact on the validity of historical costs as benchmarks.*

### 3. Finance

- *It is of critical importance that Ofgem ensures that TOs remain investable during RIO-T3 when investment levels will more than double from T2 investment levels*

### 4. Major Projects Regime

- *Early funding is vital to enable efficient network investment, timely delivery incentives should be well-targeted. Regulatory trust and certainty are needed to secure and develop the supply chain.*

### 5. Independent Technical Advisor

- *Consideration should be given to the challenges around procurement of ITA that need to be effective through the lifetime of projects without compromising delivery.*

### 6. Incentives

- *Incentives require significant changes given the challenges ET sector is facing and ongoing reforms.*

### 7. Totex Incentive Mechanism (TIM)

- *Change to the TIM is necessary. The sharing factor should be determined separately from BPI to provide suitably strong efficiency incentives whilst at the same providing suitable levels of protection to unprecedented cost rises.*

### 8. Business Plan Incentive (BPI)

- *We support the simplification of minimum requirements.*

### 9. Scale of Industry Reform

- *Certainty is required in light of extensive reforms being proposed.*

### 10. Long Lasting Community Benefits

- *Clarity required on the policy funding options and reporting.*

## 1. Process

**Challenging timescales leave no room for Ofgem delay or error and have compromised stakeholder influence.**

All parties across the RIIO-T3 working group process, at both a cross-sector and electricity transmission-specific level, recognise the highly constrained timelines for RIIO-T3 policy and business plan development, following the Future Systems for Network Regulation (FSNR) process. This creates significant challenges to develop policy and methodology development later in the process than would normally be expected.

Overall, we believe the SSMC was a positive step towards developing the RIIO-T3 framework in the time available.

SPT question the necessity of retaining a full 12 months for Ofgem's business plan assessment process. SPT have concerns as to whether the compressed timescales for TO business plan development and Ofgem's approach of placing greater reliance on working groups to develop policy and methodologies compromises input from key stakeholders. This concern was recently voiced by Citizens Advice at a T3 cross-sector working group. It is also key to note that with such truncated timescales increases the risk of unintended errors being made. We urge Ofgem to ensure that there is sufficient time afforded to ensure the appropriate stakeholders engagement is allowed and that the essential time for due diligence is undertaken.

We are waiting for key information from Ofgem that is required to enable the drafting of Business Plans and support working group discussions. For example, we note that the timelines for the preparation of the draft Business Plan Guidance (BPG) have been extended from January/February 2024, to late Q1 2024. We urge Ofgem to ensure the draft BPG is published without delay as it will be critical in ensuring network companies have sufficient time to prepare high-quality and meaningful Business Plan submissions.

**We agree it is right to reflect the most recent available scenarios, but only where there is sufficient time to both work these into detailed plans and complete the necessary levels of assurance that are mandated by Ofgem.** We note that Ofgem has indicated through T3 working groups that it may be minded to request that TOs update their draft BPDT submissions and load plans to reflect the ESO's updated Future Energy Scenarios for 2024 (FES 2024). These scenarios play a key role in network planning and updating SPT's network plans and site strategies is a considerable endeavour.

**We ask that Ofgem ensures that its publications, including the Business Plan Guidance (BPG) and SSMD are not delayed, as well as ensuring that the ESO's publication of FES2024 is not delayed (including agreement with Ofgem on the treatment of the new FES2024 framework), both of which would put the timelines for business plan development at significant risk. Timely publication of guidance is a crucial enabler of a compliant and complete RIIO-T3 price control submission.**

## 2. Cost Assessment

**We do not believe that the RIIO-T2 Project Assessment Model (PAM) is a suitable starting point for RIIO-T3.** RIIO-T3's approach should focus on engineering review of need case and optioneering to ensure that licensees bring forward the necessary investments which are developed to a level of maturity and presented with sufficient transparency.

The RIIO-T2 process was not a robust methodology for providing efficient allowances and if the PAM is retained, its application should be limited in the RIIO-T3 cost assessment toolkit to those costs which have sufficient, statistically robust benchmarks available.

The cost assessment process at RIIO-T2 suffered from a number of weaknesses that are set out in greater detail in our responses to the relevant ET consultation questions, but include:

- The PAM sought to assess comparable components of projects but did not consider risks associated with differences in cost allocation (resulting from weaknesses in RIGs cost definitions) nor consider projects as a whole, which is needed to deal with cost allocation issues and also consider asset types and costs not explicitly covered by the benchmarked component definitions.
- This combined with a downward bias on efficient unit cost selection resulted in proposed project allowances which were unrealistic at asset level and effectively incomplete at a project level.
- The asset cost data utilised suffered from a small sample size meaning that statistically significant comparisons were challenging. Attempts to strengthen the sample size by using DNO data identified major differences in asset cost definitions between TOs and DNOs and also material differences in technical specifications of similar assets meaning that DNO reported cost data was demonstrated as categorically not suitable for TO cost benchmarking.

RIIO-T3 cost benchmarking will need to consider all of the lessons from RIIO-T2 but also against recent extreme price volatility will have a significant impact on the validity of historical TO costs as benchmarks. This means that it is likely that the cost assessment and TIM mechanisms will need to operate and be calibrated holistically to ensure that adequate allowances are provided, with suitable levels of protection to TOs and customers for unprecedented cost uncertainty, whilst retaining strong efficiency incentives on TOs to outperform if possible.

### 3. Finance

**It is of critical importance that Ofgem ensures that TOs remain investable during RIIO-T3.**

In Ofgem's approach to a fair RIIO-T3 financial package it is in the interests of consumers that full consideration is given to promoting these outcomes:

- investor trust and confidence in the regulatory regime;
- investment in UK energy networks critical national infrastructure; and
- sustainable economic growth, consistent with Ofgem's Growth Duty, whilst delivering Net Zero transformation and energy security.

The financial package for a price control has never been more important than it is for RIIO-T3 due to the scale and the pace of essential investment required to the transmission network as we drive towards GB's Net Zero targets.

SPT are developing RIIO-T3 plans which will enable the drive towards Net Zero and will represent a substantial economic growth opportunity for Scotland and the UK. The scale, type, and exposure of risks in RIIO-T3 is increasing in several areas – the number and scale of projects and programmes, the associated series of delivery challenges, compressed outages, planning and consenting challenges, and reputational challenges – to name a few. We are in a position to deliver our ambitious plans despite these increased risks, however this is contingent on Ofgem setting the right financial package and balancing the increasing risks. The investability assessment must feature heavily in Ofgem's design of the RIIO-3 financial framework.

We expect to invest c.£7bn over the course of RIIO-T3 where, it is highly likely, the revenues we earn are no longer sufficient to finance this investment. We forecast, relying on RIIO-T2 financing assumptions, the requirement to inject c.£2bn of equity and raise c.£3bn of debt to finance our ambitious RIIO-T3 plans.



Ofgem must ensure the RIIO-T3 financial package is fair to customers and investors, where risks are balanced to ensure customers do not overpay for critical infrastructure, whilst ensuring investors are fairly remunerated to incentivise the inflow of capital that will fund the scale of required investment in the current and the ever changing and uncertain risk landscape.

Prospective new investors will know that the returns they will receive will be closely anchored to the level of returns set by the regulator at price controls. If that level is not attractive to new investors, they cannot be expected to invest – those investors will prefer to deploy capital elsewhere, safe in the knowledge that every nation needs to spend vast sums on infrastructure to support their own decarbonisation process creating a wide set of alternative investments. If fresh equity capital cannot be raised, then this will immediately hamper the ability of any company to deliver large investment programmes.

This presents a risk of underinvestment at a crucial time in the transition to net zero, and in an environment where there is already a concern about the risk of networks impeding the roll out of low carbon technologies. The material consequences that flow from underinvestment outweigh the costs of marginally higher bills. Ofgem need to balance the risk in the context of the current business and market conditions, as well as accounting for their new duties to take account of consumer interest in achieving Net Zero and Growth duty.

We can summarise the fundamental problem statement for the RIIO-T3 financial package as follows:

1. The nature of our business and operations is going through significant change where the total level of risks and type of risks are no longer stable across price controls, and the macroeconomic conditions have changed dramatically and are now aligned closer to the conditions prior to the great financial crisis.
2. The current approach to setting the equity return is unable to account for these future risks given the estimation is focussed on backwards looking historical data and may be knowingly set too low using a 'through-the-cycle' approach.
3. There is a severely asymmetrical risk to current and future consumers if the RIIO-T3 financial package does not promote the outcomes referenced above.

Ofgem has been clear that its proposed overall approach is to be aligned with the UKRN methodology for setting the cost of capital, and in line with the RIIO-T2 approach where possible. While this may be understandable under a 'typical' price control review where business operations scale and risks remain stable, the RIIO-T3 review represents a significant step change from the historic risk environment – both in terms of our CAPEX and scale of operations, and also in the macroeconomic environment.

The CAPM methodology is a straightforward and mechanistic estimation of the equity return in a stable business environment, however the methodology is inherently flawed at accounting for changing and future risk. Historical datasets are used in Ofgem's approach to setting the CoE parameters, meaning the model is unable to account for forward looking risks associated with the changing nature of the electricity transmission networks. Ofgem has recognised this issue:

*'we recognise that there may be evidence to indicate that energy networks face higher or lower levels of systematic risk on a forward-looking basis in the round after accounting for relevant price control mechanisms, which may not be accurately reflected in beta samples which are backwards looking.'*

The issue persists when considering Ofgem's 'through-the-cycle' stable return approach. Ofgem has suggested, in principle, this is better for investors who seek long run stable returns – however this principle breaks down when the nature and scale of the business is no longer stable. Further, this approach suggests it is acceptable for returns to be set too low, with the expectation that they may be set too high at a future review. We have not seen this 'through-the-cycle' approach in practise where Ofgem have adopted methodologies that have reduced returns in line with lower interest rates in recent reviews.

The capital markets and macroeconomic context in which RIIO-T3 is being undertaken is markedly different to when the RIIO-T2 price controls were being determined. Yields on UK government bonds have increased by 332bps since the publication of the RIIO-2 Final Determinations for gas distribution and electricity and gas transmission networks. Quantitative easing by central banks has stopped. Concurrently, the demand for capital to finance investment across a wide range of infrastructure sectors has increased, both in the UK and internationally.

There is a requirement within our Licence to maintain an investment grade credit rating. Ofgem must therefore ensure the financial package is set so we can be funded to maintain that rating and resilient to downside risks. As an example, using the current RIIO-T2 financing parameters, like WACC, to forecast key credit ratios into the RIIO-T3 period and beyond highlights a potential decrease in SPT's key credit ratios including 'Funds From Operations (FFO) / Net debt' and 'Retained Cash Flow (RCF) / Net Debt'. This is in conjunction with our forecast CAPEX / RAV ratio reaching c.20% during RIIO-T3 from an already strained position of c.12% in RIIO-T2, placing us in the high-risk category.

The Final Determination for RIIO-T2 was published at a time of extremely accommodative monetary policy. Expectations at the time were that the Bank of England base rate would remain low (even close to zero) for a prolonged period, regulatory decisions taken during the last cycle were designed to address the era of "cheap money" – in particular in respect of TMR. The UKRN 2023 guidance is reflective of that set of regulatory decisions.

Our preliminary equity return analysis suggests transmission networks would require an allowed return on equity in excess of 6.5%. This reflects electricity transmission specific forward-looking risk including the beta estimation, and a stable, not fixed, TMR reflecting the 'normal' levels of return prior to the great financial crisis (where interest rates are consistent with those we see today).

This is based on a balanced approach to bring forward looking risk. Our proposed approaches set out in the response to the finance annex remain broadly in line with UKRN guidance but relies on Ofgem using its discretion to ensure the balance of risk is accounted for in the context of RIIO-T3, taking account of their new duties and the macroeconomic conditions.

Ofgem should use the SSMC Decision to project strong financeable and investable attributes including a package that delivers strong investment grade metrics consistent with the TOs licence conditions.

#### 4. Major Projects Regime

**Early funding is vital to enable efficient network investment, and timely delivery incentives should be well-targeted. Regulatory certainty is needed to secure and develop the supply chain.**

The ASTI framework has been a welcomed step change in the regulatory treatment of major projects, enabling earlier access to funding and more streamlined regulatory treatment to support ambitious delivery timelines.

We recognise that delivery incentives for major projects have a role to play in the regulatory framework. However, to date, no financeability nor investability assessment has been completed for the ASTI ODI, which potentially includes very significant penalties across the ASTI projects. As set out in our response to Ofgem's Statutory Consultation on the ASTI Licence Conditions on 23 June 2023<sup>4</sup>, we have significant concerns surrounding the financial impact on SPT of the ASTI ODI. Not only does SPT face significant ODI penalties, but also potential enforcement action for late delivery of projects. Such penalties significantly increase financial risk in the current environment. This is appropriate given the intensive capital requirements

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<sup>4</sup> [Statutory consultation to modify the special licence conditions in the electricity transmission licences: Accelerated Strategic Transmission Investment | Ofgem](#)



associated with delivering the unprecedented capex spend in a challenging supply chain environment. We would therefore ask Ofgem to undertake a financeability and investability assessment for current and future frameworks as soon as possible.

**We urge Ofgem to ensure appropriate timely delivery incentives and dates are applied in respect of major strategic projects only and calibrated to ensure proportionality and the ongoing financeability and investability of SPT and the other TOs.** Ofgem query in the SSMC whether stronger incentivisation than under ASTI may be required during RIIO-T3. Further expansion of this highly punitive incentive risks creating significant financial strain for SPT. We propose that any ODI associated with future major projects must be of a lower magnitude than the current ASTI ODI, both ensuring TOs remain investable, and that timely delivery ODIs do not dwarf the broader set of RIIO-T3 incentives.

**We strongly support Ofgem's position that Pre-Construction Funding (PCF) and Early Construction Funding (ECF) are essential to enable the TOs to have finances readily available to progress major projects from an early stage through to beginning construction.** We have welcomed Ofgem's approach to PCF and ECF to date and believe that the progress made with these mechanisms should be carried over to the RIIO-T3 price control. We support Ofgem's commitment to provide TOs with PCF and ECF following the Centralised Strategic Network Plan (CSNP) to enable the timely progress on new transmission projects. However, to support the works that will be critical to enabling CSNP projects, PCF and ECF should also apply to non-CSNP re-openers, providing transparency on the use of the funding, consistency with other mechanisms and clear linkages to specific projects.

**We are currently forecasting an annual expenditure that will rise from just over £200m in 2020 to close to £1bn by the end of the decade. To deliver this scale of ambition we need Ofgem's RIIO-T3 regulatory mechanisms to provide greater certainty to facilitate securing resources across GB with earlier access to contract funding.**

To reduce delivery risk associated with globally constrained supply chains, the ECF regime needs to evolve from piecemeal project-by-project funding towards a capacity funding model, providing longer-term certainty of need for the supply chain to allow licensees to secure production capacity.

We propose that the ECF mechanism, evolves into capacity funding. Capacity funding would be a mechanism to allow TOs to enter into longer term supplier agreements providing certainty to both parties and securing limited capacity and de-risking lead times across the longer term portfolio view.

We would also ask the number of uncertainty mechanisms are streamlined and to take a programmatic view for submissions with larger volumes to create an agile and flexible delivery framework.

With contractor and Supplier market power the strongest it has ever been, we have engaged extensively with the market over the past 18 months to understand the market conditions and contracting options. It is clear from the feedback that longer term agreements and strategic portfolio contracting is key to securing limited capacity. Limiting the volume of tendering through allocation or strategic partnerships is key to securing capacity in the current market. The scale and timing of delivery is challenging, however, by committing to long term planning and agreements we can help build up the requisite supply chain. Our strategy is addressing these key points however Ofgem providing certainty, along with allowing earlier financial commitment, will be pivotal in it's success.

Delivery of this plan will require expansion to all tiers of the supply chain through a long term flexible contracting strategy. Our baseline delivery strategy has historically been underpinned by our disaggregated model allowing us to use our highly developed in house engineering and delivery capabilities to engage directly with tier 2 and below specialist contractors with little or no subcontracting. This approach has lowered the barriers to entry into the market developing the supply chain that was previously not accessible whilst delivering efficiently. We understand with the extensive required expansion of the transmission network to meet Net Zero that we cannot deliver solely with this approach. We have therefore sought to put in place

a £5.4bn strategic framework, currently in tender, allowing a flexible approach between the disaggregated and EPC approach.

## 5. Independent Technical Advisor

**Consideration should be given to the challenges around procurement of ITA.**

We welcome the proposals for an Independent Technical Advisor (ITA) with the intended purpose of improving Ofgem's confidence in project cost and design, which, in turn, will help speed up Ofgem's decision-making and benefit consumers. We agree there is scope for ITA involvement to accelerate decision-making, with the greatest benefit at the procurement and construction stages. Careful consideration of the benefits of ITA involvement at all project stages is required - for example, we do not see the requirement for the ITA in the early design stages of a project, when options are provided to the CSNP with initial design and programmes developed. Implementation of the ITA at this stage would risk duplication of the SO role in strategic network planning.

**It will be important for Ofgem to consult with relevant licensees to clearly define the roles and objectives, as well as the timelines for project assurance. We urge Ofgem to take a tiered approach to implementation and that continued assessment is undertaken by Ofgem to ensure that the ITA meets its intended purpose and brings consumer value.**

Lastly, we would urge Ofgem to consider the challenges around the procurement of the ITA. Our experience shows that limited external parties can execute the necessary technical audit assurance, and the use of these firms for the purpose of the ITA may have the unintended consequence of compromising the pool of external party support to TOs in the design, development and delivery of the future portfolio of transmission projects.

## 6. Incentives

**Incentives require significant changes given the challenges the ET sector is facing and ongoing reforms.**

We agree that the RIIO-T2 incentives have driven positive behaviours. However, the incentives require adaptations in RIIO-T3, and new areas for incentivisation should be considered to meet the future challenges faced by the ET sector. **Compared with RIIO-T2, RIIO-T3 brings unprecedented levels of reinforcements and connections, associated outages and rising constraint costs with an increasing focus on the resilience of our network to both climate and cyber security. Incentivisation in these areas therefore presents an opportunity to drive significant consumer benefit, but incentive calibration must reflect the highly challenging delivery environment in RIIO-T3, ensuring electricity transmission remains an attractive investment opportunity despite the significant risks and volume of RIIO-T3 investment.**

RIIO-T3 presents a challenging environment for many of our incentives, particularly ENS and the connection incentives. The ENS incentive will become increasingly challenging to meet given the volume of outages required on the electrical system to deliver both the strategic NOA/tCSNP/tCSNP2 and local works, with 15 strategic ASTI/HND projects scheduled for delivery during RIIO-T3. Ofgem should, therefore, consider a higher MWh target to meet the increasingly challenging environment presented during RIIO-T3.

The connection incentives will require significant updating, in light of the ongoing connection reform work. As part of this industry reform, which will take several years to be fully embedded, we have concerns as to whether a Timely Connections incentive is appropriate for RIIO-T3. SPT considers this incentive is no longer appropriate or fit for purpose and should be removed from the RIIO-T3 licence. The focus of the connections reform work is to move away from the current practice of processing large volumes of connections applications to unrealistic licenced timescales. Instead, the focus of the reformed regime will rightly be on

designing coordinated and cost-effective connections offers, delivering benefits to developers, the network and consumers.

In light of the significant connections reform work currently underway, which includes queue management implementation, a reformed connections process and introducing new barriers to entry, there is a clear risk that the measurement of customer satisfaction during this period would require careful consideration. We expect many customers to be frustrated with wider industry reforms that are not a reflection of the TOs' actual customer service and it will be important that such frustrations are not channelled at the TOs, through the Quality of Connections incentive, when they are in fact a broader industry issue. We implore Ofgem to ensure that this is considered in their review of this incentive.

Alongside the other TOs, we are proposing a new financial incentive relating to the Coordinated Adjustment Mechanism (CAM). The CAM was implemented in RIIO-T2 and contained no financial incentive for networks to utilise the re-opener. We suggest that an upside only incentive is applied to the CAM which protects licensees from detriment when seeking to deliver overall consumer value. We suggest that the incentivised mechanism is instated first as a trial to allow the regulator to assess the behaviours and incentive values across the licensees similar to the instatement of the SO-TO incentive. We have included further information on our proposals in the main body of our question responses, as well as our views on the proposed changes to existing incentives.

## 7. Totex Incentive Mechanism (TIM)

**Change to the TIM is necessary. The sharing factor should be determined separately from BPI.**

We agree that the Totex Incentive Mechanism has been effective at driving cost efficiencies and customer value, however, due to increased supply chain and delivery risks in RIIO-T3 we believe that the incentive rate should be reviewed and potentially lowered.

**We would welcome further discussion with Ofgem on the optimal TIM level as there is a very significant risk of material overspend in RIIO-T3, given that many electricity transmission assets have seen inflation that outstrips commonly used indices. The TIM will, therefore, need to be set in the context of the wider financial RIIO-T3 package.** Given current economic conditions such as price volatility and low-cost confidence we believe that it may be appropriate for Ofgem to consider an asymmetric TIM sharing factor. This would take the form of a higher percentage of underspend retained by the licensee and a lower percentage of overspend incurred by the licensee. We believe a higher percentage of underspend would encourage TOs to be ambitious and a lower percentage of overspend would protect licensees from market conditions whilst encouraging investment. It is key to note that this aligns with Ofgem's Net Zero duty as it will help unlock the investment necessary to build the infrastructure needed to achieve the transition to net zero.

Due to significant cost uncertainty a Confidence Dependence Incentive Rate (CDIR) based approach could create a perverse incentive for network companies to propose lower confidence or less well justified costs to seek a lower TIM, and therefore less exposure to the observed upwards pressure on costs. A CDIR-based approach would need to be designed significantly differently to the RIIO-T2 approach to ensure that network companies are not punished for high-confidence costs in the form of a high sharing factor.

Fixing the TIM at the RIIO-T2 level would expose network companies to market conditions to an unacceptable extent. This approach would be arbitrary, unfair, and would not recognise the challenges of both cost volatility and investability in RIIO-T3. It is also key to note that the TIM is utilised as intended and would urge Ofgem that it is not used as a funding mechanism.

If the Information Quality Incentive (IQI) is reintroduced as part of the RIIO-T3 framework, we propose that the more subjective parts of this mechanism should be removed or be reward only and there should be an increasing quantitative focus and transparency. We recognise that the benefits of the IQI mechanism is the clear relationship between efficiency and the totex sharing factor. We believe, however, that due to current market conditions this approach would not be appropriate. We propose that, regardless of what approach is

adopted, the TIM sharing factor needs to be determined separately from the Business Plan Incentive (BPI). If the BPI and TIM sharing factor are not determined independently this would create a perverse incentive for licensees to provide low quality Business Plans.

We are broadly supportive of an approach similar to the Quality and Ambition (QAA) approach used by Ofwat as part of their PR24 price control although we have concerns regarding the degree of subjectivity in Ofwat's approach. To overcome this, we propose that assessments of Costs and Ambition be carried out separately. This would involve a subjective review of ambition being reward only and a more quantitative assessment of costs having both an upside and a downside. We also believe that due to current market conditions the TIM sharing factor needs to be determined separately from the BPI mechanism.

More broadly it is important that cost assessments need to recognise the challenging market and supply chain conditions and that historical costs will be a poor indication of future costs. Appropriate and considered benchmarking plays a key role in the price control and recognition of the recent and current volatility in costs is essential when determining the benchmarking methodology. It is, therefore, critical that Ofgem ensures that the approach they adopt is fair and proportionate in terms of levels of information required. Ofgem must also ensure that outputs reflect real projects that TOs are delivering.

## 8. Business Plan Incentive

**We support the simplification of minimum requirements. We suggest an evolution of RIIO-T2 BPI principles is the appropriate approach however due to the lack of clarity on how the BPI will be designed, and how subjective the assessment of business plans will be, we cannot comment on the size or strength of the incentive.**

We do not consider 'truth-telling incentive' an appropriate name for this regulatory mechanism and would instead encourage a focus on 'Business Plan Quality' or using the 'Business Plan Incentive' as named for RIIO-T2.

We would welcome a simplification of minimum requirements, focused on the completeness and relevance of Business Plan submission. Minimum requirements should not be used to drive the level of ambition of the plan, which should be considered through other elements of the business plan. The minimum requirements should be clear, achievable, and able to be objectively assessed, without leaving room for different interpretations of Ofgem's guidance. Additionally, minimum requirements should not duplicate any elements of previous minimum requirements that have now transitioned to business-as-usual activities.

We support Ofgem's position to move away from Customer Value Propositions. However, we believe that an 'in-the-round' assessment of ambitions runs the risk of being highly opaque and subjective. To work this would require a clear methodology with limited room for interpretation. This would be challenging without clear and specific assessment criteria to which an 'in-the-round' assessment is unlikely to be well suited.

We agree with stakeholder feedback regarding the approach towards cost forecasts in RIIO-T2. We believe, however, that an 'in-the-round' assessment would be at least as subjective. The lack of reliable historical benchmarks and the difficulties in comparative benchmarks makes this a high-risk area for potentially unjustified penalties.

## 9. Industry Reform

**Certainty is required in light of extensive reforms being proposed.**

As industry continues to adapt to mobilise the delivery of Net Zero, we expect there to be a significant level of change introduced through the remainder of the RII0-T2 period and throughout RII0-T3. Reforms across a broad range of areas such as the energy industry codes and their governance arrangements, charging and connections, the electricity markets, the design and planning of the whole electricity system, are anticipated, as well as the introduction of competitively appointed transmission owners. **It is imperative that Ofgem provides certainty to ensure investor confidence across our industry and urge that Ofgem ensure that these changes are necessary, pragmatic and taken into account for the purpose of developing the RII0-T3 regulatory frameworks.**

The role of incumbent TOs, and their track record in delivering national critical and resilient infrastructure to decarbonise society, should not be underestimated and this should be reflected in Ofgem's decision making when introducing and or implementing any reform like the introduction of competition.

**We encourage Ofgem to consider the role of incumbent TOs in assisting in the development of reforms by drawing on our skills and expertise that will ensure energy security and resilience, while delivering continued value for consumers.** We possess the relevant, necessary, experience and expertise which can be drawn upon to support the common goals of delivering Net Zero and increasing energy security and network resilience while maintaining the most value for consumers.

## 10. Long Lasting Community Benefits

**Clarity is required on the policy funding options and reporting**

We support the UK Government's initial decision on Community Benefits for Electricity Transmission Network Infrastructure<sup>5</sup> and look forward to Ofgem and the TOs working together to develop a regulatory framework that supports the government's policy direction.

**Despite the SSMC having a limited focus on Community Benefits, we would like to draw Ofgem's attention to the need to clarify the policy funding options and regulatory reporting to implement the government's proposed community benefit guidance efficiently and effectively.** At SPEN we have a successful track record on implementing and deploying community benefit through our Net Zero Fund and Green Economy Fund, which since 2018 has delivered around £23m for local communities and business across our license area. We would welcome further conversations on this to support the shaping of community benefit funding and the associated regulatory funding mechanisms where we are happy to share our learnings and best practice from our experience.

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<sup>5</sup> [Community benefits for electricity transmission network infrastructure - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/consultations/community-benefits-for-electricity-transmission-network-infrastructure)