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Dear Steve,

SSEN Distribution response to Ofgem's RIIO-3 Sector Specific Methodology Consultation

1. SSEN Distribution welcomes the opportunity to respond to Ofgem's RIIO-3 Sector Specific Methodology Consultation. This response is on behalf of Scottish and Southern Electricity Networks' two distribution licence holders: Scottish Hydro Electric Power Distribution plc and Southern Electric Power Distribution plc.
2. With a network reach to over 3.9 million households and businesses in the North of Scotland and Central Southern England, we are a significant stakeholder in the sector and our commitment to delivering the Government's net zero strategy, working alongside Ofgem and our stakeholders is one that remains unwavering.
3. SSEN is also part of SSE PLC, one of the largest publicly listed companies in the UK, and the largest company headquartered in Scotland. SSE is the UK and Ireland's national clean energy champion and has committed to invest over £12.5bn into the economy as part of its Net Zero Acceleration programme by 2026.
4. The key points of our response are included in this cover letter. Detailed responses to the questions set out in the Overview Document of the consultation are provided in Appendix 1. We have also responded to specific questions in the gas distribution and electricity transmission annexes of the consultation where we consider there may be some read across to electricity distribution policy in Appendices 2 and 3. Finally, our response to the questions set out in the Finance Annex are provided in Appendix 4.
5. As Ofgem consults on the RIIO-3 policy framework for electricity transmission and gas, we are only in the first year of the RIIO-ED2 price control. It is therefore too early to draw any conclusions on the success of the RIIO-ED2 framework and identify any lessons-learnt, and our focus is currently on delivering our RIIO-ED2 commitments to our customers.
6. A full and separate process must be run to set the electricity distribution price control, and it is critical that decisions taken by Ofgem for other sectors do not set a precedent for electricity distribution. Each framework must be considered on its own merits, supported by a full consultation process. This will help ensure that a suitable framework is in place that considers learning from RIIO-ED2 and recognises the potential for greater divergence between sectors. This divergence between sectors, and regionally within sectors, is likely to increase as the transition to net zero progresses. The appropriate solutions for electricity distribution are therefore likely to differ from those for gas and electricity transmission, particularly in key areas such as interactions with the Regional Energy System Planner (RESP), Business Plan Incentive (BPI) and Totex Incentive Mechanism (TIM).
7. We welcome Ofgem's open approach to policy development through working groups and consultations such as this one. We will continue to engage constructively and proportionately with the process.
8. At this early stage, our response focuses on regulatory principles, with the detailed application of these principles to be worked through at the appropriate time for electricity distribution.

Key points

9. In addition to our detailed comments provided in response to the consultation questions, we have the following key points to raise.

Enabling net zero and interactions with the RESP

10. We welcome the strong focus on net zero and the proposal for networks to plan against the “Leading the Way” scenario. In Distribution, the introduction of the RESP model will create significant opportunity to accelerate investment in net zero and further support our “flexibility first” approach in a way that is transparent and meets the needs of our communities. This must ensure that we provide the best value for customers today and tomorrow in considering the investment required to deliver net zero.
11. Once implemented, the RESP model should determine the need for investment and provide external validation, in particular where plans are ambitious and may require significant additional investment to meet local ambitions. The aim should be to enable DNOs to work together with their communities to develop and implement programmes of investment and activities that span several price controls to enable net zero. This would help avoid some of the issues that arose in RIIO-ED2 when trying to set an ambitious baseline and reduce the over-reliance on more burdensome uncertainty mechanisms for net zero-related investment. This would also provide greater certainty and enable us to collaborate with our supply chain and drive efficiencies.
12. Significant further work is required to establish how the RESP model will interact with RIIO-ED3 to facilitate proactive and agile net zero investment. The ability to fully deliver the RESP model in the required timescales for RIIO-ED3 must also be considered and any interim arrangements carefully thought through.
13. SSEN Distribution is already exploring ways in which decision-making can evolve to reflect a “net zero first” approach. We are putting communities at the heart of our work, including through the successful roll-out of our Local Energy Net Zero Accelerator (LENZA) tool,¹ and testing out recommendations arising out of a study we commissioned with NERA to better facilitate investment for net zero.² We intend to share our findings of applying this approach to several test cases with Ofgem, industry and wider stakeholders, in due course.
14. We also expect the RESP model to have much wider implications, for example on how costs are assessed and the tools we use, such as the cost benefit analysis tool. RIIO-ED3 also provides an opportunity to improve how we make decision for net zero. This should include reviewing the treatment of losses to ensure they are properly valued within the price control, system planning and investment decision-making, which could deliver wider whole system benefits, for example through reduced system balancing costs.

A package of activity that is not only financeable but investable

15. As set out in SSEN Transmission’s response to Ofgem’s Sector Specific Methodology Consultation (SSMC), SSEN Distribution supports the key evidence to inform the development of the financial parameters for RIIO-3. Our view of the financial framework required for RIIO-3 is considerate of the core elements when setting a price control, namely, the cost of capital, financeability and investability³, and other financial parameters such as asset lives, capitalisation rates, equity issuance costs, and pass-through costs such as tax. Our views on the financial

¹ <https://www.ssen.co.uk/our-services/tools-and-maps/lenza/>

² <https://www.nera.com/content/nera/us/en/experience/2023/recommending-improvements-in-regulation-to-better-incentivise-st.html>

³ Ofgem do not define what is intended by the concept of Investability. We agreed with SSEN Transmission that this covers the following elements: Strong Investment Grade Credit Rating (i.e. BBB+/Baa1), Equity Returns reflective of Market Evidence, Risk Adjusted Equity Returns and Return on Regulatory Equity (RoRE) Ranges, Efficient and Fully Financed Debt Costs (including transaction costs), Appropriately Funded Costs of Issuing Equity, Long-term Stable and Predictable Regulatory Framework, and Financial Framework Reflective of Macro-economic Factors.

framework for RIIO-ED3 will evolve as we progress through RIIO-ED2 and in the lead up to the SSMC for Electricity Distribution.

16. In relation to the cost of capital, it is of critical importance that energy networks are investable which means attracting and retaining significant equity investment and support debt financing. The change in the macro-economic environment has significantly changed the financial outlook for RIIO-3. With the significant increase in interest rates since 2022, there has been a corresponding increase in the baseline equity returns required by investors and debt financing costs. The Cost of Equity (CoE) methodology Ofgem deployed in RIIO-2 set a CoE which was too low and the increase in interest rates has further demonstrated that the methodology for RIIO-2 was incorrect. Evidence presented by SSEN Transmission alongside the Energy Networks Association (ENA) illustrates that Ofgem should not simply roll-forward the RIIO-2 CoE for RIIO-3. When considering the market evidence including range of cross checks, the CoE should be increased significantly from RIIO-2 levels thereby correcting for Ofgem errors and reflecting the macro-economic environment.
17. We also believe there has been and will continue to be a material change in the business context whereby need for investment alongside complex network operations affects the risk profile in the future. The investability criteria must cover all core elements reflective of this change in risk as well as the macro-economic conditions. The evidence presented by the ENA and SSEN Transmission supports the need to consider these changes when setting the financial parameters. Overall, the CoE should be increased for the RIIO-3 period based on that evidence and change in risk profile to ensure we are investable over the price control and longer term.
18. Our financial capital requirements must cover debt as well as equity and the financial framework must ensure we can fully finance our debt on an efficient basis. Ofgem should seek to avoid making changes to the stability of the regulatory framework covering the calibration of the cost of debt mechanism and the treatment of inflation. We believe that Ofgem should be cautious making significant changes to the treatment of inflation or adjusting the definition of the notional company particularly around index linked debt without detailed justification and analysis. We will review the Cost of Debt mechanism over the development of RIIO-3 but would recommend Ofgem do not narrow any of its decisions on the design of the mechanism for Electricity Distribution until it consults at a future point through a separate SSMC. At this stage, we do not see a need for a change in the current treatment of inflation from RIIO-2 into RIIO-3 and would welcome further discussions on the options. Our provisional views on elements of the Cost of Debt mechanism, namely the transaction costs and treatment of inflation are detailed in SSEN Transmission's SSMC response. For other elements such as the calibration, averaging period, and use of a weighting mechanism will require further analysis at the Electricity Distribution SSMC.
19. The other financial parameters set in a price control need to be reviewed at the time of the Electricity Distribution SSMC covering regulatory depreciation for new and existing assets, and capitalisation rates. These elements will be dependent on analysis at that time including reviewing our RIIO-3 Business Plan, the impact on current and future customers, and the impact on broader financeability elements.
20. We believe there are some financial parameters which could be set for RIIO-3 that are reasonable and consistent with policy intent of previous price controls. For example, setting the regulatory depreciation profile for new and existing assets should reflect the intergenerational aspects of regulatory depreciation. We believe Ofgem should continue with that policy particularly given the scale of investment, balancing charges over current and future consumers, and reflecting the need to support some cash requirements.

Business Plan Incentive

21. Ofgem must be clear on the purpose of the BPI and the behaviour it is looking to incentivise: ambition, quality, or low costs. There are significant differences between each of these objectives, which can also work against each other.

22. In the context of net zero targets, Ofgem's new net zero and growth duties, and the direction of travel set out in the latest draft Strategy and Policy Statement, the BPI should reward companies that propose ambitious and realistic long-term plans to achieving net zero. These plans should be developed with local communities and may span more than one price control period. This should incentivise companies to propose the most efficient trajectory to net zero and ensure best value for money for current and future customers.
23. In that context, we consider that there could be benefits in retaining an opportunity to propose more ambitious or bespoke outputs or projects, but with clearer parameters to ensure all proposals have a genuine chance of success. Ofgem could identify key areas of focus, for example net zero, climate resilience and consumer vulnerability, inviting DNOs to put forward proposals that go above and beyond in terms of benefits for consumers and local communities, with an emphasis on shared learning and collaboration. Ofgem could consider a reward mechanism, or alternatively a funding pot similar to that already in place for GDNs.
24. We also consider that a quality or completeness component of the BPI is important and should be retained. However, minimum requirements should be drafted with greater clarity, and additional baseline requirements as were included in RIIO-ED2 should be limited.
25. In the context of rapid demand growth and the need for additional capacity, ambition no longer equals lower costs in the shorter term, but is likely to result in greater value in the longer-term. Ofgem must recognise this in designing the incentive, and ensure that companies are incentivised to submit realistic, high quality, costs and make genuinely ambitious proposals. These costs and plans should be considered in a future context for the transition to net zero and not just the short-term impact for the 5-year price control period. In the current environment, costs are widely recognised to be significantly less certain and historic costs are not a reliable predictor of future costs. On that basis, lower confidence costs should not automatically attract a greater risk of penalty in RIIO-3, and this should be reflected in the design of the BPI.
26. We note Ofgem's proposed alternative to move to a more 'in the round', qualitative assessment akin to Ofwat's approach in PR24. We do not think that such an approach would be appropriate, and it involves significant downsides such as a high degree of subjectivity and lack of transparency in how Ofgem would assess business plans. It would also be less compatible with a discrete assessment of cost ambition so would only be appropriate if cost ambition is also assessed 'in the round'.
27. Finally, the incentive in RIIO-ED2 was heavily weighted towards the downside, with limited opportunities for reward. Introducing a greater penalty exposure would further skew the incentive and would not be proportionate.

Totex Incentive Mechanism

28. In setting the TIM, Ofgem must consider the overall price control package and the challenges faced in each sector. The specific sharing rate must reflect the nature of the risks involved, and the overall balance of risk and reward, particularly as we start to deliver an unprecedented level of network investment.
29. The setting of sharing factors in RIIO-ED2 was complex and the focus on high vs low confidence costs may be less applicable in RIIO-ED3 given the current macro-economic environment. The price control mechanisms in RIIO-3 need to evolve to reflect the period of significant growth that network companies are now in. The focus should be on ensuring ambitious net zero plans; this may mean more costs could fall within the lower confidence category. A fixed sharing approach could therefore also be considered, however further detailed work is required specifically for electricity distribution to fully assess this.

Interactions with cost assessment

30. There are clear interactions between the BPI, TIM, and the cost assessment framework. For RIIO-ED3, Ofgem will need to review the cost assessment methodology to ensure it is fit for purpose for net zero. As noted above, we commissioned NERA to carry out a review of regulatory arrangements to understand how these could better drive a more strategic approach to investing in networks in Summer 2023. The report includes several

recommendations that relate specifically to the cost assessment framework for distribution.⁴ In addition, the scale of investment required and competition for resources means that it will no longer be appropriate for Ofgem to rely solely on a historical approach to setting costs.

31. We have not provided responses on the detailed cost assessment questions for gas and transmission. However, during RIIO-ED2, we raised a number of concerns with the cost assessment methodology. These will likely remain valid in the context of RIIO-ED3 and include reflecting well-evidenced regional differences in the methodology, and ensuring catch-up efficiency targets and unit rates are ultimately reflective of market conditions. We would welcome early discussions with Ofgem on how the framework should evolve for RIIO-ED3.

Resilience to climate change

32. In addition to the strong focus on delivering net zero, we agree it is critical that Ofgem fully considers the impact of climate change on network resilience as we move into RIIO-ED3. Climate change is having a growing impact on our networks, with six named storms occurring between October 2023 and January 2024. Storms cause a range of issues across the network including unanticipated impacts such as flooding at sites that have not previously been identified as being at risk.
33. The price control framework must allow us flexibility to respond to these events and provide investment for targeted network resilience as new risks emerge, as these can be unpredictable and may not be clear at the time of the business plan submission. Whilst the consultation document is clear on the requirement for long-term resilience strategies, the link between these strategies and Ofgem's approval of funding for climate-related network investment as cases arise during the price control period is less clear. Ofgem must provide clear guidance on the level of resilience it expects and is willing to fund.
34. In this changing climatic environment, consideration must also be given to whether the current Interruptions Incentive Scheme (IIS) is fit for purpose. The IIS model was set up in a very different climatic environment and the RIIO-3 must be updated to reflect the current conditions, with consideration also given to incentives for higher resilience by design. We would highlight this as an area for further analysis in advance of RIIO-ED3 with particular focus on target setting and whether faults that occur during exceptional events should be excluded from the daily average performance.

Communities and Stakeholders

35. Communities and stakeholders will continue to be fully integrated into our business plan development in RIIO-ED3. This was a valuable part of the process in RIIO-ED2 and an area that we now consider to be part of our business as usual. As noted above, we continue to find new ways to collaborate with our local communities and wider stakeholders. We share data, knowledge and insight with a view to developing ambitious multi-price control plans that meet local and national net zero ambitions. Our Customer Engagement Group (CEG), now known as the Powering Communities to Net Zero Group, remains active in an enduring role, and continues to provide valuable independent challenge and scrutiny.
36. We are not clear that feedback from RIIO-2 has been taken account of in Ofgem's stakeholder engagement proposals for RIIO-3. Specifically, feedback highlighted that whilst it was clear that business plans were developed with significant stakeholder input, it was unclear to what level stakeholder views were factored into Ofgem's decision making. This remains a gap under Ofgem's RIIO-3 proposals and is an area where further work must be done to establish clear guidance on how Ofgem intends to align its decision-making framework to the new ISG stakeholder engagement process.
37. We welcome Ofgem's proposal for the role of the Independent Stakeholder Groups (ISGs) to extend to holding network companies to account in the delivery of RIIO-3 plans. As stated above, we have implemented a similar

⁴ [Recommending Improvements in Regulation to Better Incentivise Strategic Investment in GB Electricity Networks \(nera.com\)](https://www.nera.com)

approach in RIIO-ED2 and have found this to be valuable. It is important however that this enduring role considers any interactions between the ISG and existing decision-making processes already in place by Ofgem.

Conclusion

38. RIIO-ED3 will provide significant opportunities to work with our communities to deliver net zero ambitions and build a network that is resilient to climate change. This must be underpinned by a supportive regulatory framework, that recognises the challenges and opportunities our sector is facing and the wider macro-economic environment. The RIIO-ED3 framework will also need to reflect the conclusions of the upcoming National Infrastructure Commission review into electricity networks, once completed.
39. We look forward to engaging with Ofgem, industry and our stakeholders as we prepare for the next set of price controls. If you have any questions in relation to our response, please do not hesitate to contact me.

Your sincerely,

Clothilde Cantegreil

Head of Strategy – SSEN Distribution