



Sector Specific Methodology Consultation:

SGN Response

06/03/2024

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Dear RIIO-3 Team,

### **Sector Specific Methodology Consultation**

Thank you for the opportunity to respond to the Sector Specific Methodology Consultation (SSMC) at this critical point of regulatory and policy uncertainty.

SGN is a gas distribution network that transports gas to 6 million customers and over 116,000 commercial and industrial customers in the Southern and Scotland licence areas. We serve the most densely populated regions of central London and the most sparsely populated regions of Scotland, and we pride ourselves in the high levels of customer service that we provide to them all.

The first years of RIIO-2 have been very challenging. Since the start of RIIO-2 we have faced unprecedented challenges in the cost of energy, the COVID pandemic, labour shortages, supply chain risks, interest rate volatility, and unfunded inflationary cost pressures. These pressures have had a significant regional impact, specifically in our Southern region, which has resulted in substantial cost challenges and a significant over-expenditure forecast for the RIIO-2 period.

We are acutely aware that our customers have also found this time particularly challenging, and we have responded to help them wherever possible. This is evidenced by SGN maintaining very high customer satisfaction scores in both our Scotland and Southern regions, with Scotland continuing to lead nationally with the highest customer satisfaction score for the 7<sup>th</sup> year in a row<sup>1</sup>. We have paid specific attention to our most vulnerable customers, recognising in particular that SGN must support those in fuel crisis. We refocused our commitments in 2023 to focus on four strategic areas:

- i. **Direct services for customers.** Covers SGN's Additional Services resources and vulnerability training for our frontline teams as well as our Careline and Safe & Warm community teams.
- ii. **Supporting priority customer groups.** National and local partnerships designed to reach those most vulnerable with energy safeguarding services via trusted intermediaries including Scope, Marie Curie, Age Scotland, Age UK, NHS health services and Maggie's Cancer Centres.
- iii. **Fuel poverty and energy affordability.** National & local partnerships with local authorities, Citizens Advice, Citizens Advice Scotland, National Energy Foundation, Fuel Bank Foundation, NEA & Wise Group, MyBnk, YES Energy Solutions and the SGN Safe and Warm Community Scheme in partnership with Centre for Sustainable Energy.
- iv. **CO awareness initiatives.** National & local campaigns, partnerships with regional Fire and Rescue teams and education programmes for young people in schools, universities, and Scouts.

<sup>1</sup> RIIO-GD2 Stakeholder Report 22/23 SGN <https://www.sgn.co.uk/sites/default/files/media-entities/documents/2023-07/RIIO-GD2-Stakeholder-report-2023.pdf>

Through our partners we have supported over 326,000 households<sup>2</sup>, with over 33,000 home safety interventions, 54,000 crisis funds, 56,000 energy advice services, 110,000 income maximisation checks, and a host of other services. Since April 2021 we have had 76 vulnerability and carbon monoxide allowance (VCMA) initiatives approved, allocating £44m with an average Social Return on Investment (SROI) of £11 for each £1 invested.

We have also focused internally on engaging and building the Repex supply chain in the Southern region to deliver the outstanding work and build for delivery into RIIO-3. We recognise that, whilst costs are increasing externally, we need to be absolutely focused on ensuring that every £ is spent as efficiently as possible and are focusing our efforts to ensure that our frontline staff are as safe and efficient as possible, managing working time fatigue standards whilst maintaining our standards of service.

Looking ahead to RIIO-3 there are specific and complex challenges that we will need to address with the regulator to secure the most appropriate outcome on behalf of customers, stakeholders, and investors. This will be necessary to avoid unintended consequences in later price controls and be consistent with the statutory framework regarding the interests of future customers and the ability of licensees to be able to finance their activities over the long-term, not solely within a quinquennial price review period.

Our response expands further on these points. Below we set out our view on the importance of delivering for our customers, delivering safely under all scenarios, and maintaining safety and resilience at a time of intense ambiguity, all while reinforcing the importance of maintaining investability and financeability during the energy transition.

### **Importance of delivering for our customers**

There has been a step change in costs in RIIO-2. As SGN operates in both Scotland and Southern England we have clear visibility of the significant regional cost differences between the North and the South of the UK. By way of example, extreme labour shortages persist within the skilled and semi-skilled workforce in Southern England. These cost pressures are anticipated to increase into the foreseeable future. To maintain safe and reliable delivery for our customers we must ensure that the cost of operating efficiently in Southern England is accurately reflected in RIIO-3.

This is a particularly pertinent issue for the final years of the Repex programme. The HSE Iron Mains Risk Reduction Enforcement Policy mandates that all iron pipes  $\leq 8"$  diameter and within 30m of a property are decommissioned by December 2032<sup>3</sup>. Throughout RIIO-1 and RIIO-2, we have prioritised a subset of these pipes with the highest risk for completion during the period. Innovation, good project design and better ways of working have helped reduce the cost for consumers. As we approach the end of the programme, however, there is a high portion of challenging work remaining that cannot be tackled through innovation, and a body of smaller projects created by changes in policy that need to be completed. This remaining Repex work requires careful consideration in the cost assessment working group and may require changes to both the way that we report data and the way in which we assess costs.

A second issue is the impact of moving from a relatively stable cost base to one with increased volatility. This introduces a significant challenge for how Ofgem should assess the alignment between costs and deliverability and introduces a significant risk that benchmarking networks with low-cost pressures will impose unreasonable final determination outcomes on regions that experience high-cost pressures. Penalising networks for regional costs that are an unavoidable product of the geographical location risks jeopardising delivery and risk undermining the financial stability of those network areas. This will cause significant consumer detriment without achieving the objective of penalising inefficient delivery.

The approach to assessing cost forecasts in a volatile economic climate with increasing cost pressures and more complex workload characteristics will be a significant challenge for historically focused cost assessment

<sup>2</sup> SGN statistics on social contribution

<sup>3</sup> SGN GD2 Business Plan – Repex Appendix - [https://www.sgn.co.uk/sites/default/files/media-entities/documents/2022-07/Appendix-019-SGN-Repex\\_0.pdf](https://www.sgn.co.uk/sites/default/files/media-entities/documents/2022-07/Appendix-019-SGN-Repex_0.pdf)

models. It will also introduce challenges for the business plan incentive and how cost ambition should be balanced with deliverability when networks will have different levels of complex work remaining, often determined by regional and geographical considerations. In our response to the FSNR<sup>4</sup> we suggested open book contracting or technical assessment approaches to managing this uncertainty. It is SGN's view that this should remain an option for consideration.

### **Delivering energy safely under all future energy scenarios**

SGN takes its legal obligation to deliver energy safely to the 6 million domestic households and over 116,000 connected commercial and industrial sites extremely seriously. On average over the last 5 years gas consumption for domestic and commercial customers in the UK was 385,000 GWh/yr. of natural gas, approximately double the 193,000 GWh/yr. of electricity<sup>5</sup>. This ratio has stayed relatively consistent over the last five years on an annual basis. During cold snaps, local gas demand can peak up to eight times higher<sup>6</sup> than the equivalent electricity demand.

We need to maintain investment in safety and resilience all the time that customers are on the network, and the network is energised. Our core safety related investment programme, that we will present in our RIIO-3 plan, will be independent of the scenarios for decarbonisation set out in the Future Energy Scenarios. Investment in safety remains a consistent priority for our consumers and stakeholders and is fully supported by our Independent Stakeholder Group.

As it stands, however, there is no clear consumer led pathway to decarbonising heat. The uptake of developed technologies such as heat pumps remains lower than anticipated. In 2023 there were just over 12,845 low carbon boiler upgrade voucher redemption requests received, of which approximately half concerned exiting gas<sup>7</sup>. The observed installation rates<sup>8</sup> for heat pumps were only 17% of the installation rate forecast for 2023 under the FES (future energy scenarios) 'falling short' scenario, and 8% of the 'leading the way' scenario. The contrast between forecasts and actuals at the end of the first year of the 2023 FES report undermines confidence in the FES scenarios as scenarios, let alone as a forecast to plan against. In any case, investment is planned against the safety risk described above, not a policy scenario.

It therefore remains important to continue investing in alternative decarbonisation pathways. SGN's shareholders have supported significant additional investment in the H100 project to demonstrate that 100% hydrogen is a viable, cost effective and attractive option to customers for decarbonising domestic heat. We remain confident that hydrogen will be an important part of the energy mix to our industrial and domestic customers. We are also confident that there is significant opportunity to expand biomethane production in areas of our network. It is important that we maintain optionality for the UK decarbonisation pathway, and it is important that such projects/options continue to be delivered in RIIO-3.

This is particularly important for our 116,000 industrial and commercial customers who use over 40% of the gas that we transport. These entities are distributed across our networks and face similar uncertainty and risk associated with decarbonisation policy. They include over 12,500 industrial sites, over 19,500 schools and hospitals, and over 84,500 offices, hotels shops and entertainment venues<sup>9</sup>. Whilst we rightly focus on our most vulnerable domestic customers today, these commercial and industrial customers drive economic growth and jobs, and we need to support them to avoid greater levels of vulnerability in the future. If green gases such as hydrogen and biomethane can support their business at least-cost, then this needs to be supported.

### **Maintaining a safe and resilient network in an environment of intense ambiguity**

<sup>4</sup> Future Systems and Network Consultation: SGN Response 19/05/23SNR Consultation, pg. 13 & pg. 19

<sup>5</sup> Digest of UK Energy Statistics, Annual data for UK, 2022. [DUKES 2023 \(publishing.service.gov.uk\)](https://pubs.ukers.org.uk/)

<sup>6</sup> UK Energy Research Centre, 2018, Challenges of decarbonisation of heat: local gas demand vs electricity supply Winter 2017/18, Wilson, Taylor and Rowley <https://ukerc.ac.uk/news/gas-consumption-during-beast-from-the-east/>

<sup>7</sup> <https://www.gov.uk/government/statistics/boiler-upgrade-scheme-statistics-december-2023>

<sup>8</sup> <https://www.gov.uk/government/statistics/boiler-upgrade-scheme-statistics-december-2023>

<sup>9</sup> SGN assessment of customer data as captured through Xoserve.

The gas networks are facing an unprecedented level of ambiguity regarding the future energy and regulatory landscape. This ambiguity is driven by a legally binding commitment to deliver net zero by 2050<sup>10</sup>, uncertainty around the deliverability of net zero scenarios as set out by FES<sup>11</sup>, Ofgem's aspiration to "diversify customers away from gas"<sup>12</sup> and the current reluctance of customers to do so<sup>13</sup>.

We welcome Ofgem's recognition in the SSMC that *"In setting our price controls, we have regard to the need to ensure that network companies can finance their activities. On this basis we must plan to recoup the cost of past and future investment from current and future customers"*<sup>14</sup>.

However, with the evidence demonstrating that we are not on track to meet our 2050 Net Zero targets, there is an unparalleled Government policy risk regarding what measures will be implemented in order to deliver the 2050 targets and a Regulatory policy risk as to how and when the regulatory approach will change. The consequence of acting too early for today's customer is a significant and unnecessary increase in bills, whilst undermining the financial resilience of the network for tomorrow's customer. The consequence of acting too late is that today's customers are undercharged for investments that need to be recovered and it places a disproportionate share of the costs on future customers and increases the risk that costs cannot be recouped from the customer base.

### **Maintaining investability and financeability during the energy transition**

The ambiguity and risk associated with maintaining a safe and resilient network (see previous section) have a direct impact on the cost of operating gas networks today. Messaging within recent consultations on the role of gas networks<sup>15</sup>, the level of confidence in the FES scenarios for the purpose of investment<sup>16</sup>, and the future role of hydrogen for heating<sup>17</sup> has heightened this sense of risk. There is clear market evidence that a perception of increasing risk is already impacting the cost of raising new debt and the duration of that debt for GDNs. Evidence from debt markets shows that the cost of debt in the GD sector is increasing relative to electricity networks and tenors on new debt issuance in the GD sector are shortening due to investor uncertainty over network utilisation and ESG considerations. Furthermore, the credit rating agencies are increasingly reflecting on this in their considerations. The reduction in the available tenor of debt significantly increases the risk to equity investors and sits alongside and distinct from the impact of an increasing cost of debt on the cost of equity. Both will feed through to the cost to consumer incurred through a higher cost of capital and will undermine our ability to give proposed long-term assurances on sufficiency of resources.

Messaging from Ofgem and Government is clearly driving risk into the market and onto both debt and equity investors without providing a clear long-term plan for mitigating those risks. Whilst statements recognising that investors taking on asset stranding risk is likely not in the consumer interest<sup>18</sup> are welcome, they provide limited comfort without a clearly communicated solution, supported by a full assessment of the challenge, thorough impact analysis and appropriate mitigations.

We have an obligation to maintain investment to ensure safety and reliability across the full breadth of the network, irrespective of aspirations or scenario-mapping to deliver net zero by 2050. To secure investment in maintenance, safety, and reliability of the network over this period we have to maintain attractiveness to investors for the retention and the availability of both debt and equity capital by being both investable and financeable.

We welcome the position Ofgem has taken that there is a need to avoid creating an asset stranding risk for Gas Networks and that costs should be recouped from current and future customers<sup>19</sup>. However,, we note

<sup>10</sup> <https://www.legislation.gov.uk/ukpga/2008/27/part/1/crossheading/the-target-for-2050>

<sup>11</sup> FES 2023 Data workbook <https://www.nationalgrideso.com/document/283061/download>

<sup>12</sup> Jonathan Brealey Keynote speech to Ofgem conference: Clean, affordable, secure: a conversation about the future of the energy system, 23/02/24

<sup>13</sup> <https://www.gov.uk/government/statistics/boiler-upgrade-scheme-statistics-december-2023>

<sup>14</sup> RIIO-3 Sector Specific Methodology Consultation – GD Annex, Dec 2023, para 1.13.

<sup>15</sup> Consultations on Frameworks for Future Systems and Network Regulation: Enabling an Energy System for the Future. Para 2.12.

<sup>16</sup> Sector Specific Framework Consultation <https://www.ofgem.gov.uk/publications/riio-3-sector-specific-methodology-gas-distribution-gas-transmission-and-electricity-transmission-sectors>

<sup>17</sup> NIC 2<sup>nd</sup> National Infrastructure Report <https://nic.org.uk/studies-reports/national-infrastructure-assessment/second-nia/hydrogen-for-heat-annex/>

<sup>18</sup> Sector Specific Methodology Consultation, Finance Annex, para 1.7, pg. 7

<sup>19</sup> RIIO-3 Sector Specific Methodology Consultation – Overview Document, para 2.38, Finance Annex, para 1.8.

that the proposed solution of accelerated depreciation is the only solution within the regulatory toolkit, and other solutions are potentially ultra-vires for Ofgem at this stage. It is our view that this limits Ofgem's, and the SSMC's, ability to address the problem at hand. Operating within these constraints risks sub-optimal decision making and a disregard of options that may be more beneficial or required in the future, it is incumbent of Ofgem to consider all options before concluding.

Traditional investors in energy infrastructure businesses have been looking to invest in a lower-risk environment. Investors that invest in higher-risk environments have very different expectations as regards return on investment. In the light of the uncertainty described in the paragraphs above there needs to be reassurance on: (1) how Ofgem's regard to the need to secure that licence holders are able to finance their licenced activities will be delivered in practice through the energy transition; (2) how Ofgem will maintain its obligations to protect the interests of future consumers in relation to gas conveyed through pipes in the event that policy aspirations are not realised; and (3) how costs will be recovered in the event that policy aspirations are realised and there remains an obligation on Ofgem and the networks to protect the public from the dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes.

Investability and resilience are key for the GDNs in ensuring that the sector is equipped to maintain a safe and reliable gas supply in line with the consumer and social interest. We encourage a holistic approach with Government and other stakeholders to consider the optimal way of managing these issues through RIIO-3 and beyond and would like to support this process to ensure that the impacts of alternative pathways are fully understood and viable solutions to managing policy risk are implemented over the long-term assessing investability and financeability over multiple price control periods.

It is our view that this risk can be managed most effectively through a firm backstop commitment from government that investors will be able to continue efficiently investing in the safety and resilience of the gas networks and they will not be exposed to the risk of not recovering their investment.

In the meantime, the confidence of debt and equity investors that their investments will be recoverable in the long-term has been undermined and in the absence of the assurances set out above, it is important that the risk is appropriately compensated.

The issues raised around cost recovery, de-energisation, and decommissioning are complex and all need to be considered against a backdrop of extreme customer and policy uncertainty and issues around affordability due to the current cost of living crisis. To ensure a fair transition for all customers, the impact on investability needs to be considered, as without investability there is no financeability.

We recognise that the issues identified above are complex and challenging to regulate, and that there is a risk that without careful consideration they will create tensions between GEMA's objectives and duties, and the regulatory mechanisms designed to deliver them. Accordingly, we would propose the following principles:

1. A collaborative approach with Ofgem, Government and gas networks to resolve how Net Zero investment risks are managed, support a 'Just Transition' for all current and future energy customers, and undertake an assessment on the impact on the most vulnerable in our society.
2. An explicit commitment as a part of the RIIO-3 settlement that historic and future investments and costs will be recoverable in line with stated policy intent<sup>20</sup>.
3. To ensure that efficient costs on significant deliverables are funded for specific networks by having sufficient regard to regional cost drivers and reasonable expectations for future costs and workloads characteristics.
4. To maintain support for alternative decarbonisation pathways, which enhance optionality and reduce the risk to the most vulnerable and those at risk of being left behind on the journey to net zero.

<sup>20</sup> RIIO-2 Sector Specific Methodology Consultation – Finance Annex para 1.8, pg. 7.

5. To provide sufficient and timely opportunities for transparent consultation and engagement throughout to enable networks to deliver quality plans, and Ofgem to determine accurate cost allowances that investors can have confidence in and avoid compromising the ability of this or future price control ability to deliver against the challenges ahead.

Thank you for your attention to the above matters and consideration of our response to specific questions. We have responded within 3 appendices consistent with the SSMC. We remain committed to our role as a responsible and innovative gas network operator. Should you require any further information with regards to our response then please do not hesitate to contact me at [David.Handley@SGN.co.uk](mailto:David.Handley@SGN.co.uk)

Yours faithfully,



David Handley  
**Director of Strategy and Regulation**  
**SGN**



## Summary of Response to Questions

	SSMCQ & No.	Position	Headline message
OVQ1.	Do you agree with our proposal for how RIIO-3 should interact with the Hydrogen Transport Business Model?	Disagree	We recognise that RIIO-3 needs to interact with the proposed Hydrogen Transport Business Model (HTBM) however it is too early to determine the nature of that interaction and there is a risk that such decisions prematurely constrain the role of the gas networks. It is important to: (i) recognise that industrial demand is distributed across our network and accounts for 40% of the gas we transport; and (ii) to play close attention to the boundaries between the role the existing gas networks have and the projects being delivered through the HTBM. It is SGN's view that there is a need for an integrated system of biomethane, hydrogen and blended hydrogen. To create artificial divisions at this point risks restricting optionality later.
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?	Agree	There are a large number of additional activities that require funding through RIIO-3 if networks are going to continue to successfully support the development of the hydrogen transport infrastructure and repurposing of gas networks. These include: (i) evidentiary work prior to heat policy decision; (ii) trials and testing to support the evidence base; (iii) technical verification and validation of operating models; (iv) the transition strategy that ensures safety and reliability; and (v) opportunities to repurpose the network. Funding these activities in RIIO-3 is required to appropriately balance the interests of and promote fairness between current and future consumers. Without this work the heat policy decision may take longer or be taken with less robust information.
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?	Agree	We agree with Ofgem's proposal that network costs associated with blending at both distribution and transmission level should be funded through RIIO-3 uncertainty mechanisms and consider many of the existing structures to be appropriate for facilitating this. We have set out examples of projects that we would anticipate may be required in RIIO-3 under each of the mechanisms according to the stage of their technological and commercial development cycle.
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)?	View	There will be a requirement during the RIIO-3 period to ensure flexibility and responsiveness to manage the uncertainty surrounding the use of hydrogen for heating. It will be critical to work closely with the RESP and NESO to progress toward net zero, and key to this will be engaging with customers and stakeholders - industrial, commercial, and domestic. It is essential that this work is appropriately funded, and we believe that the funding mechanisms that are available in RIIO-2, set out in our response to OVQ3, provide an appropriate base for RIIO-3.
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?	Disagree	We disagree with the proposal not to fund further evidence relating to the repurposing of the existing network for hydrogen prior to the hydrogen heat policy decision in 2026. Such a decision would send a very negative signal to the market, reduce the options available to the UK economy to decarbonise heat, and would risks locking the UK into a higher cost and less socially acceptable decarbonisation pathway. Until there is a clear pathway which is led by customer demand to appropriately balance and promote fairness between current and future customers interests in the journey to decarbonise domestic and industrial heat, all options should continue to be developed 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?	Mostly disagree	<p>As it stands there is insufficient evidence to establish the appropriate course of action for decommissioning costs. The current assessments have identified a broad range of uncertainty around the costs which is to be expected given the technical requirements of de-energisation and decommissioning of the network is still very poorly understood, particularly at the level of the distribution network. There are also significant social and welfare implications that would need to be considered before any conclusion can be reached.</p> <p>RIIO-3 provides the timely opportunity to progress the evidence base on which to assess options and their impacts, however, before any anticipatory funding is implemented, we think that there needs to be evidence led assessment as to the plausibility of the FES scenarios to ensure that current consumers are not paying unnecessarily or overpaying for scenarios that may not materialise.</p>



	SSMCQ & No.	Position	Headline message
OVQ7	Do you agree with the proposal to use the FES framework for selecting the RIIO-3 scenarios?	Strongly Disagree	We disagree with the proposal to use of the FES framework for selecting the RIIO-3 scenarios as they do not represent the investment decisions that need to be made by gas networks during the RIIO-3 period and market evidence does not suggest that the FES scenarios are robust. Investments by gas networks is driven by an absolute requirement to maintain safety and reliability within our network. By using the FES scenarios, we risk undermining investment required for safety, undermining investment required for security of supply, distorting the bill implications of network proposals, and undermining financeability.
OVQ8	Do you agree with the proposal to use FES Leading the Way as the planning scenario for ET in RIIO-3?	Disagree	There is a significant risk that FES 'Leading the Way' will not be realised, and as a result, whilst we support the objectives of delivering net zero by 2050 and recognise the requirement to invest ahead of need, we also recognise that this may lead to over-investment. We need to have strong confidence that the need will materialise, and appropriate leading indicators and checks should be in place to ensure investment commitments are evidence based rather than aspirational scenario based. As identified in OVQ7, the assessment of the bill impact should not be based on Leading the Way until there is evidence of customers behaviours changing in the manner anticipated by FES.
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?	Disagree	As set out in the response to OVQ7 investment in the gas network is driven by the need to maintain safety and resilience of the gas network. The FES scenarios give a view on customer demand and customer numbers and how they may change to deliver net zero. As a gas network we must invest according to safety, even if the change in numbers presented by FES was plausible it would have negligible impact on the investment proposals presented. As such we disagree with the appropriateness of using the FES scenarios as a relevant point of reference for the gas networks in RIIO-3.
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?	Disagree	Our previous responses to OVQ7 and OVQ8 which discuss our view of how the use of FES is inappropriate for planning purposes should be understood as part of our response to OVQ10 and could run contrary to GEMA's duty to maintain safety and security of supply. On this basis we think that a common gas network scenario should be driven by a forecast of when the last customer disconnects from a section of network and investment needs to be maintained until that point. Currently this is unknowable, and the market evidence and current policy position suggests it will not be for a considerable amount of time.
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?	Disagree	Our view is that alternative FES scenarios is likely to have very limited impact on the investment decisions being undertaken, as the FES scenario are incompatible with the investment case that we need to make to maintain security of supply and safety. The updated FES scenarios, which we understand will move from 4 to 3 and remove "falling short" are likely to be even less compatible.
OVQ12	Do you agree with our proposed approach on the role, scope and format of PCDs?	Agree	Ofgem proposals for retaining both evaluative and mechanistic PCD's are welcome, as is the proposal that the networks should look to reduce any regulatory burden associated with them. It is our view that PCDs provide for an appropriate level of transparency particularly for where costs are excluded from the cost benchmarking methodology and for supporting the roll-out of ambitious and novel projects supported by our customers and stakeholders. Where a PCD is related to an uncertainty mechanism, however, it is important that the costs are appropriately allocated to minimise the risk of perverse incentives through incorrectly defined unit costs.
OVQ13	Do you agree with our proposed framework for setting financial incentives? Are there any additional considerations that we should take into account?	Mostly Agree	We agree with Ofgem's proposal to continue the financial incentivisation of companies, we recognise the desire for network companies to work together and the collaborative street works incentive is a good example of this. We also need to recognise that customer expectations continue to evolve, and incentives provide an effective incentive to keep pace with these expectations. We continue to have concerns about an over reliance on penalty-based incentives and the use of dynamic incentives.
OVQ14	Do you agree with our approach to setting reputational incentives? Are there any additional considerations that we should take into account?	Mostly Agree	We agree with the proposed retention of reputational incentives and consider that they have an important role to support internal and external focus on a specific topic. However, they need to be used sparingly, with a clearly defined scope that is of relevance to the consumers as the reporting burden associated with them is significant.

	SSMCQ & No.	Position	Headline message
OVQ15	Do you agree with our proposals for bespoke outputs? Are there any additional considerations that we should take into account?	Agree	We agree with the desire to minimise the number of bespoke incentives and agree in principle that customer should have a similar level of service, however, we also recognise that some geographical regions have strong local policies, and it is right that networks should look to support them and be incentivised to do so if that brings about a business change.
OVQ16	Do you agree with our proposal to retain the EAPs and AERs in RIIO-3? Please provide reasonings for your position.	Agree	We agree with Ofgem's underlying principle that network companies should look to further minimise their impact on the environment and improving transparency of networks actions and progression in line with the targets set out within the environmental action plan. We believe that PCDs provide an important role in ensuring that funded commitments are delivered for customers and networks are transparent in their delivery or account for non-delivery.
OVQ17	What are your views on the new proposed AER format with Commentary and KPIs?	Agree	We support Ofgem's proposal of being transparent and reporting on what actions we are taking to improve our environmental impacts, including progress against targets. It is important that these reports should align as far as possible with other reporting standards to reduce the reporting burden, and KPIs should be focused on relevant metrics that show improvements against a clear objective or target.
OVQ18	Do you agree with our minded-to position of retaining the reputational incentive on Tos and GDNs for reducing their BCF?	Agree	We support Ofgem's proposal for retaining the reputational incentive on TOs and GDNs for reducing their business carbon footprint (BCF). It is important to agree an approach to shrinkage and leakage whilst a verifiable Science Based Targets methodology is being developed for the oil and gas sector.
OVQ19	Are there any other suggestions you would like to make regarding reporting standards?	Agree	We support proposals that keep the reporting as simple as possible and as closely aligned to existing and emerging reporting standards as possible to reduce the reporting burden placed on networks, reduce confusion, and to deliver comparability with sectors that are not regulated by Ofgem.
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.	Mostly Agree	We agree with Ofgem's minded -to position overall, however, in RIIO-2 the environmental score card was only applied to a limited number of customers. It is our view that as a financial incentive and it does not seem to have a strong sector or geographical specificity. As such the change that Ofgem is looking to implement is broadly consistent across all networks and it should therefore be broadened to all networks if it is going to be continued to provide a level of consistency. However, it is important that this does not duplicate information in the 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.	Mostly Agree	We believe that there is a benefit associated with incentivising network companies to deliver to a higher environmental standard and a financial incentive will motivate greater improvements than a reputation incentive in isolation.
OVQ22	Do you have any views on our proposals for the NARM framework?	Mostly Agree	We broadly support Ofgem's proposals for the framework's direction and working towards a long-term monetised risk measure for RIIO-3. However, we have concerns on the potential funding adjustments set out in the NARMs handbook, the burden of the annual reporting requirements and expanding the role coverage of NARMs beyond the existing asset groups.
OVQ23	Do you have any views on our proposed long-term approach to embedding climate resilience, including the principles for embedding climate resilience?	Agree	We agree with the need for more proactive engagement on climate change resilience and we broadly agree with the principles that are set out and the establishment of a 'climate resilience' working group. Given the unique characteristics of the individual networks and the different ways in which the climate resilience risk is realised we think that it is important that this group considers gas and electricity assets separately but linked through common principles. We also consider that there could be a rationale for including climate change resilience within the NARMs methodology, however, we need to consider carefully how this would be realised in practice given the range of uncertainty and highly geographical nature of the climate related risk.
OVQ24	Are there any early learnings we should be aware of/incorporate to make progress on this in RIIO-3 or beyond?	Agree	Gas networks have demonstrated a very high level of network resilience and reliability with network reliability over the last 3 years being 99.995%. This resilience supports the continued use of gas networks for securely delivering hydrogen and green gas. Recent storms have shown how damaging intense rainfall can be, however, there are significant challenges of forecasting exposure to weather related events. Increasingly we are considering secondary resilience impacts associated with the extended outages of telecoms or electricity.

	SSMCQ & No.	Position	Headline message
OVQ25	Do you agree with our suggested approach for embedding climate resilience into RIIO-3, namely: introducing resilience strategies; developing forward-looking resilience metrics; and introducing climate resilience working groups?	Mostly Agree	We agree with the proposed approach, however, we are cautious about whether it will be possible to embed climate change resilience into RIIO-3 in a timely manner and whether it will materially change the decisions that are taken in the business planning process. On this basis we think that it is important to maintain a reopener which enables applications for funding as the principles develop and that this reopener should cover both reactive and pro-active activities.
OVQ26	Do you agree with the proposals that we have set out around the resilience metric?	Mostly Agree	We agree that it is important to focus on resilience, we are not clear on what is implied by a resilience metric, and we are conscious that 'climate resilience' and associated roles and responsibilities can vary significantly according to stakeholder perception. We also need to recognise that networks are one part of a broader energy system, where resilience can be impacted from multiple interactions. Clarifying the scope, roles and responsibilities is an area that required collaborative development.
OVQ27	Do you agree with our proposals on workforce resilience?	Agree	We agree that workforce resilience is important and needs to be carefully managed. However recent experience demonstrates that workforce resilience is linked to factors that we can control (such as training) and factors that we cannot (such as COVID, Brexit and competition from other sectors etc). We therefore agree that workforce resilience should not be an area of formal performance targets.
OVQ28	Do you agree with our proposed key objectives for truth telling and efficiency incentives?	Partially Agree	Whilst we recognise the objectives set out within the paragraphs 7.15 and 7.16 of the consultation overview document, we consider the term 'Truth Telling' to be inappropriate and pejorative. It is very important that business plans should be deliverable and that forecast costs should be a true reflection of expectations. It is not in the interest of current or future customers to set allowances at levels that are below the cost of delivery and therefore undeliverable in the same way that it is not in their interests to set too high and over-rewarded. We would advocate for a Business Plan Quality Incentive (BPQI) that promotes a consistent, deliverable, transparent and high quality business plan.
OVQ29	What are your thoughts on our proposals relating to minimum requirements under an evolved BPI approach?	Agree	We agree in principle with Ofgem's proposed approach to minimum requirements, however, we require greater clarity what constitutes minimum requirements, what the minimum requirements are expected to cover, and how they will be articulated. Having clearly defined minimum requirements is important to support transparency and comparability between plans.
OVQ30	What are your thoughts on an 'in the round' assessment of cost forecasts as opposed to a high/lower confidence breakdown and assessment?	Partially Agree	We agree in principle with the proposal that there should be greater clarity on how 'cost confidence' can be delivered for technically assessed projects that fall outside of the benchmarking process. Given the volatility in the market, and the limitations on the accuracy of the benchmarking models, the benchmark is not a robust basis to which to define a financial penalty for cost forecasts and such an approach would be duplicative with catch-up efficiency. An 'in the round' assessment would be inappropriate as such an approach would fail to appreciate cost challenges based on their own individual merit, a risk called out specifically by Ofgem within the SSMC.
OVQ31	What are your thoughts on an 'in the round' assessment of business plan ambition as opposed to requiring and assessing CVPs?	Disagree	We believe that the CVP can certainly be improved through the mechanisms that have been set out. This would provide greater clarity to networks and consumers as to the basis of the reward and would improve transparency on the reasons why a CVP is awarded. An 'in the round' assessment of CVPs would risks failing to recognise the individual unique merit of the CVPs put forward for our stakeholders.
OVQ32	What are your thoughts on the size and strength of any truth telling incentive?	Disagree	We believe that the cap and collar of +/- 2% of the total price control settlement value is significantly in excess of what is reasonable and would not be in customers interests. In RIIO-2 for SGN this could have resulted in a reward or penalty of +/- £53m. Given the recent volatility and uncertainty surrounding future costs, such incentives levels risk networks over promising on cost efficiency benefits and then underdelivering. This would not be in consumers interests.
OVQ33	What are your thoughts on any alternative approaches that could be used instead of an evolved BPI?	Disagree	The RIIO-2 process applies a ratchet in that the lower of modelled costs vs submitted costs is utilised for setting allowances. A potential alternative approach to drive efficient costs could be to remove this ratchet, enabling a benefit to be derived through the cost assessment process directly. Whichever approach is chosen, as a point of process it

SSMCQ & No.		Position	Headline message
			is important that Ofgem makes this visible as early as possible so it is effective as an incentive scheme to influence change within company's business plan submissions.
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?	View	We would suggest that Ofgem should de-couple the setting of the sharing factors from the cost confidence approaches, and as such disagree with the three options that Ofgem propose to calculate the sharing factors. While cost confidence should be an important consideration when setting the sharing factors, there are further considerations including the wider regulatory regime and the financeability positioning. We note the setting of the TIM sharing factors is not required to complete the Business Plan guidance and can be determined later in the process.
OVQ35	Do you agree with our proposal to retain the Net Zero Re-opener with its current scope and parameters for RIIO-3?	Agree	We agree that the retention of the Net Zero reopener as an appropriate reopener mechanism for RIIO-3. It provides an appropriate backstop for changes in government policy which is appropriate given the high levels of uncertainty.
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?	Agree	We agree it is appropriate to retain the Net Zero and Re-opener Development Fund UIOLI for RIIO-3 and should continue to be used to fund early development work for Hydrogen Pre-FEEDs and FEEDs as well as whole system themed projects. We believe it is premature to reach a conclusion on the interaction of the Net Zero Re-opener development Fund UIOLI with the HTBM and other funding mechanisms, the projects delivered under the Net Zero Re-opener development Fund UIOLI in RIIO-2 should continue whilst also progressing with other decarbonisation projects for GDN's.
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?	Agree	We agree with Ofgem's initial position to retain this specific re-opener mechanism during the RIIO-3 period.
OVQ38	Do you have any views on consolidating the net zero related re-openers and the UIOLI allowance?	Disagree	It is SGN's view that the mechanisms should be kept separate as they each provide distinct and valuable services.
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?	Agree	We agree that the appropriate mechanisms should be in place for electricity and gas distribution companies to continue to participate in collaborative projects where the benefits are realised for both gas and electricity customers.
OVQ40	Do you agree with our proposal to allow physical security costs to be submitted through a broader resilience re-opener?	Agree	Yes, we would fully support the approach of maintaining the physical security reopener particularly with DESNZ currently undertaking a review of its physical security policy. We also agree that it may be desirable to integrate this to a broader resilience reopener.
OVQ41	Do you agree with our proposed approach to introduce a resilience re-opener?	Agree	Yes, we would fully support the approach to the resilience reopener. Recent years have demonstrated the importance of improving resilience, however, we need to be clear on what the expectations are, and what is reasonable to submit through the reopener.
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?	Partially Agree	We agree with the use of the Opex escalator for where operating costs are clearly variable and can be attributed to a unit cost. It is however important to differentiate between fixed and variable operating costs.
OVQ43	Do you have any views on how we should effectively monitor the delivery of Ums?	View	We recognise the increased number of uncertainty mechanisms within the RIIO-2 price control to better deal with flexibility in the rapidly changing energy space, we also recognise this increases regulatory burden with assessing and monitoring such variant allowances. We believe this should be tackled with ensuring regulatory guidance and licence drafting is robust to prevent any unintended consequences. While Ofgem has put forward two possible options to monitor the delivery of UMs, we note these do not correct the underlying issue of lack of clarity through the cost assessment process of defined outputs against allowances.

	SSMCQ & No.	Position	Headline message
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?	View	It is important that the RPE methodology evolves in RIIO-3 to improve the accuracy of the RPE data sets and the timeliness of how the data flows through the cost assessment models. It is also important that the ongoing efficiency methodology is reviewed to account for the most up-to-date and are relevant data.
OVQ45	Do you have any views on the potential application of RPEs and ongoing efficiency to re-opener applications?	View	We do not consider that it is appropriate to apply ongoing efficiency to reopener applications on the basis that reopener applications normally relate to one off costs which are unlikely to be impacted by wider productivity improvements. For Real Price Effects consideration will be needed only if costs are forecast or currently achieved. If costs had already occurred in would be inappropriate to apply RPEs as the real cost would already be put forward, but in areas where future costs are forecast based upon CPIH inflation, it would be appropriate to ensure a RPE adjustment is applied.
OVQ46	Do you agree with our proposed approach to cyber resilience in RIIO-3?	Mostly Agree	We agree with many of the proposals set out and acknowledge Ofgem's proposal to streamline this area and reduce the regulatory burden particularly in relation to simplifying the PCD's, reducing the number of PCD's and linking back to the CAF position in line with section 11.3. However, we do not think that the assessment of cyber investment or the outputs that are delivered are yet mature enough to include the costs within baseline allowances.
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?	Agree	We believe the flexible allowance (NIA as is) is a critical element in ensuring innovation can be explored at pace in our sector and support the retention of such a mechanism.
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?	Agree	We believe the competitive element is a very useful mechanism to enable innovations that are relevant to our strategic challenges in the sector and support the retention of a SIF-type competition.
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?	View	We believe that the structure of the price control innovation funding is currently working well and is aligned with a focus on whole systems problems and other public sector initiatives, as such we are not aware of a compelling case for change, the evidence base or the scale of impact identified that are motivating some of the proposed reforms.
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?	Agree	We agree with the proposal to continue with a similar level of innovation.
OVQ51	Do you agree there is a need to expand the scope of innovation funding to be more inclusive of third parties?	Disagree	It is SGN's view that the challenge of including third parties is not as significant as it is made out to be and would encourage evidence to support whether there is a genuine challenge or not. We are concerned that it is an easy accusation, but, in reality, almost all innovation projects conducted by the sector involve a third party. We believe the networks play an important role reviewing and supporting ideas from 3rd party providers and supporting their development.
OVQ52	What are your views on us establishing an accelerator to support early-stage innovators?	Disagree	We are surprised that Ofgem is proposing to establish an accelerator to support early-stage innovators and would encourage Ofgem to clarify the problem that it considers such an accelerator would address. We are mindful that investment vehicles for start-ups is a highly specialised area of work, and it is not clear how this would fit within Ofgem's remit or expertise. As such, we would therefore like to understand the proposals in greater detail.
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?	View	We broadly agree with Ofgem's proposal, however, would want to understand the basis of the accelerator in greater detail to then determine the most appropriate method through which it should be funded, and how the overall fund size should be adjusted, if it is progressed.
OVQ54	Do you have evidence of potential innovation projects that have not been implemented or sought funding due to the	View	Within the RIIO-2 price control SGN successfully applied for three PCDs for innovation projections that would not have been implemented had they not been funded directly via the PCD. It is our view that a similar structure needs to remain in place to enable projects in RIIO-3.

SSMCQ & No.	Position	Headline message	
five-year structure of the price control? How could this issue be addressed?			
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?	Agree	We support the objectives of the future regulatory sandbox (FRS) and support its intention of informing changes to the rules governing energy network activities.
OVQ56	What topics could FRS trials usefully focus on and why?	Agree	The FRS is at an early stage of development for the gas networks, it may be that the current UNC mechanisms provide a sufficient structure, but we agree that it is important to have an alternative pathway if they do not.
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?	Mostly Agree	We are surprised by the suggestion that not enough network innovation funded projects are rolled out as this is not our experience. Since the submission of the RIIO-2 business plan where we identified each project and their stage of roll-out, there has been significant change to the originally agreed themes and eligibility criteria. As a result, projects were restricted to those focused on the energy transition and supporting vulnerable customers. We have not seen any evidence on roll-out being either high or low, but this change will have had an impact. The term ‘roll out’ implies a high level TRL moving quickly into production for efficiency benefits within RIIO-1, this does not align well with the innovation themes set for RIIO-2 and there is a risk that a step-change in innovation strategy does not manage expectations for the expected short-term benefits.
OVQ58	What are your views on the design of potential new mechanisms to address this?	View	Any mechanisms that are introduced need to be carefully considered and could result in unintended consequences. Innovative process should acknowledge the risk of failure and challenges in deployment as such we would be strongly against any penalty mechanisms or performance-based incentives. The conversion of an innovation into commercial reality remains challenging, and in RIIO-2 we specifically requested funding to enable this on a number of technologies and this approach should be retained in RIIO-3.
OVQ59	Do you have any views on the timelines for modernising regulatory reporting?	View	We support the move to modernising regulatory reporting, however, there are many dependencies that need to be resolved which makes the timeline look challenging. We should also recognise that this will require investment of time and resources from Ofgem and the networks.
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?	View	We highly support the initiative to enhance the efficiency of providing regulatory information, recognising the broader scope of regulatory reporting that encompasses various submissions from Gas Distribution Network companies to Ofgem. There are challenges in this area to overcome, and SGN is actively pursuing solutions in that arena to the extent these are within its control.
OVQ61	Are there areas of regulatory reporting that would be most beneficial to start with in the modernising project?	View	To determine the areas of regulatory reporting that would yield the most significant benefits in the modernisation project, we propose to prioritise those with substantial administrative complexities and a high potential for efficiency improvements.



## SGN's Response to Specific Questions

### Appendix 1- RIIO-3 Sector Specific Methodology Consultation – Overview Document

#### 1. SGN's observations on the SSMC Section 1. Introduction

- 1.1. In the introduction of the SSMC Overview document Ofgem refer to the duties that Ofgem's governing body GEMA must be guided by when setting strategy, setting policy priority, and makes decisions on regulatory matters. The principal objective that GEMA must operate under is "to protect the interests of existing and future consumers in relation to gas conveyed through pipes"<sup>21</sup> where the interests' should be taken as a whole to include;
  - Their interests in the achievement of (i) the net zero carbon target and (ii) compliance with five-year carbon budgets;
  - Their interests in the security of the supply of gas to them; and,
  - Their interests in the fulfilment by Ofgem of the designated regulatory objectives when it carries out its regulatory functions.
- 1.2. In performing these duties GEMA must have regard to;
  - The need to secure, as far as economical, all reasonable demand for gas conveyed through pipes are met;
  - The need to secure that licence holders are able to finance their licenced activities;
  - The need to contribute to the achievement of sustainable development;
  - The particular interests of individuals who are disabled, chronically sick, of pensionable age, with low income and residing in rural areas; and,
  - Whilst it is not currently in legislation, a duty to support economic growth.
- 1.3. GEMA must carry out these functions and duties in a matter that GEMA consider to 1) best calculated to promote efficiency of licenced entities and the efficiency use of gas conveyed, 2) to protect the public from the dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and 3) secure a diverse and viable long-term energy supply.
- 1.4. We are highlighting these objectives, duties, regulatory objectives, and functions as balancing across each of them at this time of change becomes increasingly challenging. Having regard to delivering the 2050 net zero targets, whilst having a particular regard to vulnerable customers at a time of potentially significant change, whilst protecting the public from dangers arising from the conveyance of methane and ensuring that licence holders are able to finance their licenced activities creates a set of challenges that need to be considered within its entirety. It is SGN's view that the regulatory framework and the allocation of risk needs to be carefully balanced to deliver the best outcome for all parties.
- 1.5. We welcome the fact that Ofgem have opened the debate on how these objectives should be fulfilled, and we urge Ofgem not to implement short term actions that may have unintended consequences until all options have been considered and assessed.

<sup>21</sup> UK Gas Act, 1986, section 4AA, updated for legislative changes to Jan 2024. <https://www.legislation.gov.uk/ukpga/1986/44/section/4AA>



In the consultation Ofgem differentiate between the requirements of investability and the need to seek fresh equity from investors as an issue solely for electricity transmission and the reduction of gas demand<sup>22</sup> and associated implications for consumer fairness as issues solely for gas distribution and transmission. In our response SGN evidence why the two are equally applicable to all sectors and that investability is an equal issue for gas distribution and transmission and consumer fairness is equally an issue for electricity transmission.

## 2. SGN's Observations on the SSMC Section 2. RIIO-3 Sector Specific Methodology Consultation at a glance

- 2.1. We fully support the four key outcomes that Ofgem have set out in Section 2 of the SSMC overview document and agree that they are all important in the decision-making process for RIIO3. We would, however, suggest that a fifth outcome is needed to complete the 'golden thread' that will feed through the RIIO-3 suite of documents. Our customers are at the heart of everything we do as a gas network and as such we believe that customers should be explicitly named as a fifth string to the golden thread as we continue to support them through a changing and uncertain time for the energy sector.
- 2.2. As part of our duty as a gas network, we make a conscious effort to ensure all our customers remain safe and warm and commit to making a positive impact in the communities we serve, with a focus on supporting those who are vulnerable. With the use of VCMA funding we have been able to support those in fuel crisis, with 109 safe and warm partner organisations, 326,227 households supported, and £44m of VCMA fund allocated in the RIIO-2 journey so far. We need to ensure these customers feel seen and protected throughout the RIIO-3 planning process.

## 3. SGN's observations on the SSMC Section 3. RIIO Process

- 3.1. We set out below our observations on the business planning process; this covers topics of timing, the enhanced customer engagement process, engagement with Ofgem prior to submission, and engagement with Ofgem post submission.

### Timing of submission and publications

- 3.2. We welcome the indicative timeline set out in the section 3 and would welcome clarity on key aspects as early as possible.
  - **Timing of business plan guidance.** We understand from the working groups that draft versions of the business plan guidance will be released from March onward for comments with an expectation to finalise in June. This is late publication date for a July submission. We are supportive of a process that generates clarity, reduces the risk of misinterpretation, in a timely manner and look forward to engaging on this basis.
  - **Timing of Business Plan Data Tables.** Alongside the business plan guidance, it is vital we have as early sight as possible on required reporting requirements that will be within the BPDTs. Any delay in this process, or the late request of enhanced data will undermine the ability to provide high quality information and should be considered alongside the timing of release of the BPDTs.
  - **Timing of the draft submission.** It is our understanding that Ofgem are considering aligning the submission of the draft business plan data templates (BPDT) and commentary with the RRP submission on the 31st of July.

<sup>22</sup> Para 2.35 and 2.36 RIIO Sector Specific Methodology Consultation – Overview document

- **Timing of final business plan submission.** It would be helpful to agree a submission date so that we can start arranging board assurance meetings early. It is our view that this should be either the first or second week of December.
- **Sector specific methodology decision (SSMD).** Our ability to reflect the SSMD will depend on the timing of its publication. Realistically, for changes to be progressed through the assurance process prior to July submission is a 4-6 week period (depending on the number of touchpoints a change has). Changes in policy which require assessment will take longer.
- **Impact assessments.** As set out in our response, there are decisions that have significant customer welfare implications, particularly for the most vulnerable customers. Given the impact of these decisions, it is important that the scope of impact assessments which help to inform these decisions are consulted on separately and in advance of the decision being made.

There is a risk that delays in the provision of robust Business Plan Guidance and decision documents may compound the timelines and the effort required of resources which may be involved in other regulatory submissions. This can cause increasing pressures to ensuring high-quality information is provided to Ofgem, and as such should be considered alongside the overall assessment of any business plan incentives.

#### **Enhanced customer engagement framework and independent stakeholder groups (ISGs)**

- 3.3. The consultation<sup>23</sup> also identifies that there will be engagement sessions on 'guidance on RIIO-3 Enhanced Engagement framework (including the role of Independent Stakeholder Groups (ISGs))'. However, at the recent Working Group<sup>24</sup> it was confirmed that the enhanced stakeholder engagement framework would not be ready for the draft business plan guidance until later in the year, after the initial March draft.
- 3.4. SGN is well advanced in the customer engagement process, we maintained a Customer and Stakeholder Engagement Group (CSEG) through-out RIIO-2, which we now refer to this as our Independent Stakeholder Engagement Group (ISG). The ISG has clear terms of reference and governance agreed which we have kept broad to enable flexibility and responsiveness to any future guidance. The ISG has also informed and improved our customer engagement programme which is already firmly established and delivering actionable insights. We are concerned at the risk of a misalignment between robust processes that are already underway and changing expectations that may be presented in the enhanced engagement framework.
- 3.5. If there are significant changes in the enhanced engagement process from RIIO-2 or a change in the expectations, then it is especially important that these are identified at the earliest opportunity as change of approach will take several months to implement, collect new data, and inform decisions.

#### **Engagement to prior to business plan submission**

- 3.6. We recognise that, with ongoing uncertainty around key policy decisions, the issues identified within our response to the SSMC are complex and challenging to regulate and we believe that there is a risk that, without careful consideration, they will create tensions between GEMA's objectives and duties, and the regulatory mechanisms designed to deliver them both within the RIIO-3 price control and potentially future price controls.
- 3.7. It is important that there is sufficient and timely consultation engagement around key decisions, clear guidelines around stakeholder engagement, and clarity and transparency around the methodology and its application of decision documents and guidance throughout RIIO-3.

<sup>23</sup> Para 3.6 RIIO Sector Specific Methodology Consultation – Overview document

<sup>24</sup> CSWG10, 20<sup>th</sup> February 2023

- 3.8. This will enable networks to deliver quality plans, and for Ofgem to determine accurate cost allowances that investors can have confidence in. This will ensure that the process itself does not compromise the ability of the price control to deliver against the challenges ahead.
- 3.9. In particular, we would support;
- Consistency of information by validating the guidance and templates provided and to facilitate the provision of information in the correct format for the cost assessment process. This was a common theme through-out our response to both the FSNR Open Letter<sup>25</sup> and the FSNR consultation<sup>26</sup> that we believe will support careful consideration of any variances and the identification of the most appropriate cost drivers.
  - Ofgem's intention to streamline the business planning process. The consultation<sup>27</sup> states that *'Business Plan Guidance which sets out the information that should be included in the Business Plans and examples of best practice, while giving companies agency to push the frontier on the quality of Business Plans'*. We look forward to receiving this guidance and are fully supportive of a process that generates clarity, reduces the risk of misinterpretation, and look forward to engaging on this basis.
  - Constructive working groups we are able to discuss, present ideas and receive feedback on Ofgem's current thinking. We note that there are some particularly challenging questions that need to be covered off through the working groups and going forward a helpful focus could be placed on;
    - Areas for discussion: There are areas for debate where information and thinking will benefit from iterative discussion and shared views – e.g., enhanced stakeholder engagement, business plan guidance, EJP's, Index linked Debt, inflation leverage options, accelerated depreciation, investability, financeability resilience, scenarios, sector-specific risks, innovation, interaction with HTBM, appropriate ongoing efficiency, and reviews of different modelling approaches.
    - Worked examples: Needed to enable decisions in the build-up to business plan submissions - e.g., debt calibration, stranding risk, repex costs including how to best define repex complexity, appropriate drivers to determine efficient costs, disaggregated/mid-model approaches, and areas of normalisation that need built within the business plan data tables.
    - Submitted evidence: We expect to be submitting evidence in the form of independent expert reports. It is important to have a discussion on the points raised so there is a common understanding of the next steps.
- 3.10. We need continued engagement between now and the SSMD to ensure that Ofgem is making fully informed decisions. Where there are matters of immediate policy it is helpful to lock down decisions early. Where there are areas of broader policy with multiple interdependencies it is important to keep options open until the debate has taken place; this is particularly important for many of the new policy areas discussed in this submission which risk creating regulatory instability if not fully debated.

#### Engagement post submission.

- 3.11. We recognise that the period post business plan submission is a challenging period for Ofgem, and it is important for networks to engage with Ofgem in a timely and constructive manner to ensure that you have information available. It is our view that agreeing principles in advance can assist with this process.
- **Periods of assessment.** It would be helpful to have common understanding of the phases that Ofgem are working through in advance to achieve the draft and final determination stages and to have clear periods where network representations will be valued and supportive.

<sup>25</sup> 22-10-31 – SGN Response to FSNR Open Letter.pdf

<sup>26</sup> 19.05.23 – SGN response to FSNR Consultation Ofgem Confidential.pdf

<sup>27</sup> Para 3.3RIIO Sector Specific Methodology Consultation – Overview document

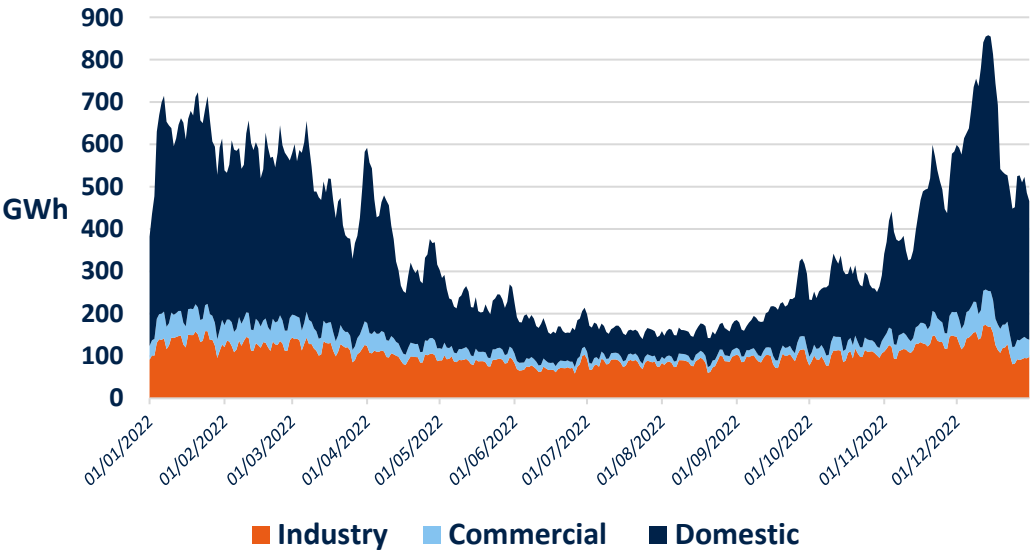
- **SQ and RFI processes.** Having clear process in advance for both SQs and RFIs in terms of time available to respond, and expectation pre- and post-issuance. We think that RFIs always benefit from discussion in advance and agreement of what is achievable by all networks in agreed timelines.
- **In the round assessments.** A number of policies set out in the Sector Methodology consultation refer to in the round assessments. It is important to have clarity from Ofgem on how any 'in the round assessment' will be undertaken, what sort of evidence or analysis will be utilised to support any views or decisions, what timelines will be used, and how Ofgem will ensure a consistent responsive approach is always utilised. An improperly calibrated 'in the round' assessment can cause unintended reputational or financial pressures on companies, and a full impact assessment should be conducted ahead of any such assessment. Not doing so would reduce transparency of the regulatory process, decreasing confidence in the assessment approaches utilised.
- **Data Quality and Model error correction process.** Network companies can provide an important service to identify model errors that will naturally occur in a complicated cost assessment process. In order to do this appropriately, Ofgem should ensure companies have access to appropriate information in a timely way and build time within the post submission and DD/FD timeline to ensure feedback can be provided prior to DD/FD publication.

## 4. SGN's response to SSMC Section 4. Future of Gas

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

- 4.1. **We recognise that RIIO-3 needs to interact with the proposed Hydrogen Transport Business Model (HTBM) however it is too early to determine the nature of that interaction and there is a risk that such decisions prematurely constrain the role of the gas networks. It is important to: (i) recognise that industrial demand is distributed across our network and accounts for 40% of the gas we transport; and (ii) to play close attention to the boundaries between the role the existing gas networks have and the projects being delivered through the HTBM. It is SGN's view that there is a need for an integrated system of biomethane, hydrogen and blended hydrogen. To create artificial divisions at this point risks restricting optionality later.**
- 4.2. In the consultation (para 4.8), Ofgem set out that they are expecting the Government to provide an update in Q2 2024 on its approach under HBTM to funding development expenditure and that this should include feasibility studies. Accordingly, Ofgem considers funding the development expenditure for hydrogen infrastructure to be out of scope for RIIO-3.
- 4.3. Without having access to the expected Government update we think that it is premature to draw such a conclusion. It is our view that the proposals could inadvertently restrict options for future decarbonisation at least cost by prematurely constraining the role that existing gas networks will play in delivering the proposed infrastructure.
- 4.4. Figure 1 shows the daily profile of gas transported through our Scotland and Southern networks according to customer segment.
- 4.5.

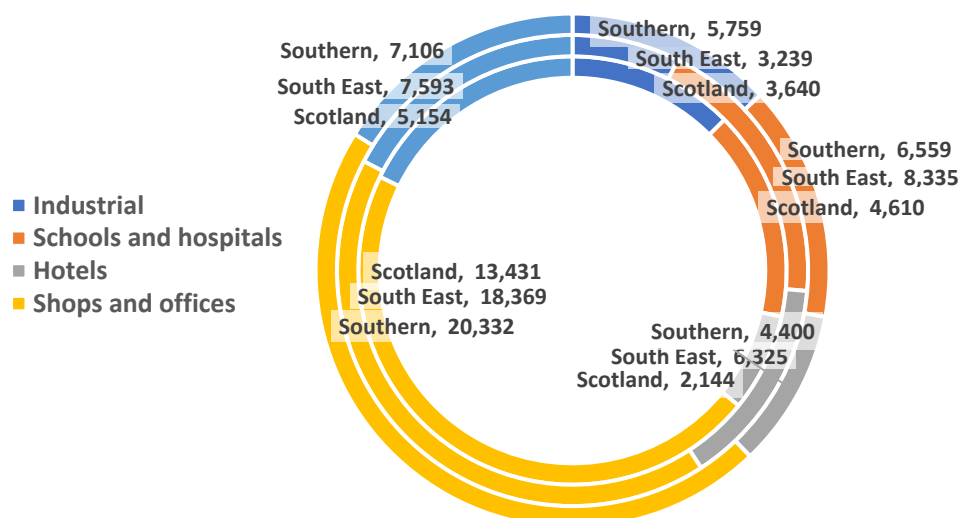
Figure 1: Daily throughput on SGN Networks according to customer<sup>28</sup>.



- 4.6. It can be seen in Figure 1 that approximately 40% of the gas that flows through our network is delivered to industrial and commercial customers. Our 116,000 industrial and commercial customers use approximately 40% of the demand that we transport and is distributed across our networks, these include over 12,500 industrial sites (such as distilleries, glass manufacturers, consumer products, food processing and consumer products), over 19,500 schools and hospitals, over 12,500 hotels and nearly 72,000 offices, shops, and entertainment venues. Whilst we rightly focus on our most vulnerable domestic customers today, these commercial and industrial customers employ our customers, and we need to support them to avoid greater levels of vulnerability in the future.
- 4.7. GDNs play in supporting the local economy, with 116,000 commercial and industrial customers that depend on our network for energy, and thousands of jobs that they support, as shown in Figure 2. There is a risk that creating an artificial distinction between industrial business models being managed by DESNZ and domestic customers being managed by Ofgem would miss the interlinkages between the two.

<sup>28</sup> SGN assessment of Xoserve data on daily transportation load by customer segment.

**Figure 2: Numbers of I&C customer by type on according to local distribution zone<sup>29</sup>.**



- 4.8. As explained in OVQ4, it will be critical for GDN's to work closely with the RESP and NESO to progress toward net zero, and key to this will be engaging with customers and stakeholders - industrial, commercial, and domestic. There is also a risk that the critical planning function provided by RESP and NESO will not be ready in time for RIIO-3. Therefore, it is SGN's view that there is a role for networks to support the planning and development of an integrated energy network that serves all customers whether it is biomethane, hydrogen or natural gas to provide resilience and security of supply and there should be appropriate funding to enable this. Not to fund this early system integration would introduce a risk of delay and reduce optionality for the deployment of hydrogen to the detriment of consumers.
- 4.9. Whilst we are supportive of the interaction between RIIO-3 and the HTBM, we need clarity on the impact the Energy Act has on the development of new hydrogen infrastructure in relation to the entities that can own and operate the new hydrogen pipelines under the HTBM proposal and existing gas transporter licence holders such as SGN. It is not clear how these new RAB based models will work and their compatibility with existing regulatory models such as RIIO or the impact on existing natural gas assets that could transition over to a new hydrogen entity.

#### **Example of interaction between HTBM and remaining network**

- 4.10. As an example, our pre-FEED studies currently underway, Aberdeen Vision, and H2 Caledonia will deliver early-stage hydrogen transportation projects, including detailed pipeline routes, cost estimates and deliverability timescales. The outcomes of these would form the basis of the HTBM to link hydrogen production, demand, and storage, and deliver regional and national hydrogen pipeline networks that comply with the following:
- Enabling the timely fuel switching of carbon intensive demand.
  - Providing energy security and system resilience.
  - Alleviating system constraints across the energy system, providing flexibility in energy management.
  - Potential to repurpose existing assets to achieve cost savings.
  - Links to the wider delivery of energy across the whole energy system at a regional and national level.

<sup>29</sup> SGN assessment of Xoserve data.

- 4.11. Within our pre-FEED studies the proposed infrastructure has been categorised into different sections (i) those larger trunk lines which are key to linking production, storage, and demand, aligning with the HTBM ambition: and (ii) smaller spur lines which connect the new infrastructure to the existing gas networks and distributed production and offtake locations. These spur lines will enable the conversion of the existing infrastructure to deliver hydrogen for transport, Industrial and Commercial consumers, and electrical generation resilience. Where a positive outcome to the Heat Policy decision is made by UK government, these spur lines could also enable hydrogen for heat at lower incremental cost to consumers. It may therefore be more appropriate for these spur lines to be funded through a RIIO-3 mechanism, where a needs case can be developed to enable grid conversion to benefit existing gas consumers.
- 4.12. These examples have been funded through the Use-It-Or-Lose-IT (UIOLI) allowances and have proven successful in RIIO-2 for GDN's to support the funding gap for early development work. It is our view that they are good examples of the works that need to be completed to inform decision making of the RESP and the NESO. It is important that Ofgem carrying this mechanism forward in recognition that this will support the transition to low carbon in RIIO-3 for our commercial and industrial customers.

**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?**

- 4.13. **There are a large number of additional activities that require funding through RIIO-3 if networks are going to continue to successfully support the development of the hydrogen transport infrastructure and repurposing of gas networks. These include: (i) evidentiary work prior to heat policy decision; (ii) trials and testing to support the evidence base; (iii) technical verification and validation of operating models; (iv) the transition strategy that ensures safety and reliability; and (v) opportunities to repurpose the network. Funding these activities in RIIO-3 is required to appropriately balance the interests of and promote fairness between current and future consumers. Without this work the heat policy decision may take longer or be taken with less robust information.**
- 4.14. The gas networks have been working closely with DESNZ over the RIIO-2 period under their Hydrogen Programme, to deliver the evidence to aid government in making their Heat Policy decision around the role of hydrogen in domestic heating. This delivers an important outcome for the consumer by supporting more informed decision making and reduces the risk of being locked into a higher cost decarbonisation pathway unnecessarily. Below we have set out six areas of additional activity that we think are important to delivering a better customer outcome and should be funded.
- **Evidentiary work prior to the heat policy decision.** We have provided a significant amount of evidence to DESNZ in RIIO-2 and anticipate there will still be a requirement to instigate evidentiary work prior to the Heat Policy decision being announced in 2026. DESNZ noted this was an iterative process and there may be a requirement to assess, reassess, and develop further evidence leading up to the final decision. Without appropriate funding mechanisms networks will not be able to complete the evidentiary work, and this will result in a significantly protracted process and possible delays to the decision. Our pre-FEED studies mentioned in the response to OVQ1, are early-stage project development but are also evidentiary in character by demonstrating the buildability of new networks and developing the methodology for network conversion.
  - **Trials and testing to support the evidence base.** There will also be a requirement to fund additional work with ongoing trials that may roll over into RIIO-3 or require additional development work, RIIO-2 examples include H100 Fife project and LTS Futures, future projects may include Multiple Occupancy



Buildings and specifically the decarbonisation of high rise and high-risk buildings. These are key areas to understand the role hydrogen can play in meeting net zero.

These are examples of critical projects that require funding to support the Heat Policy decision. As an example, further demonstration of additional operational activities with the LTS, such as in-line inspections and pipeline repair methods, along with investigation and testing of network installation components such as PIG traps and valves would deliver additional evidence. Further full-scale testing on vintage pipe material, including fracture toughness testing is needed to provide important assistance in understanding the differences between the transportation of natural gas and hydrogen. Understanding such phenomena and the development of relevant standards would bring repurposing of the LTS to a Technology Readiness Level 9.

- **Technical verification and validation of our operating models.** This will include the training, tools and equipment, and internal policy frameworks, which are crucial enabling activities that will be required to facilitate the secure and sustainable transportation of hydrogen. This, along with developing digital solutions for hydrogen network data need to be delivered irrespective of the Heat Policy decision in 2026, and delaying these activities therefore unnecessarily risks timely policy execution.
- **Developing a transition strategy to always ensure safety and reliability.** In the SSMC Ofgem proposes (para 4.11) that under the HTBM where an existing natural gas asset is to be repurposed to transport hydrogen, then it may require a transfer of the asset to take place between the existing asset owner and the new hydrogen transportation entity. Whilst we understand the principle, the practicalities are significantly more complex, and the basis of this asset transfer would have to be very carefully considered. Firstly, we would need to ensure that there is no adverse impact that risks compromising the security of supply provided to natural gas consumers or the safety of both natural gas and hydrogen systems. Secondly, we would need to have a clear physical demarcation of the assets including telemetry, and monitoring equipment but also the regulatory, network code and financial demarcation. Finally, there will need to be a clear understanding regarding the transfer of liabilities associated with that asset, along with a clear methodology through which financial basis of the transfer will be undertaken.

Associated with the above transfer of assets for hydrogen, as demand for natural gas reduces as predicted, the impact of reduced flow through existing natural gas assets will need to be understood, such as the change in flows through Pressure Reduction Stations, which could have a material impact on the safe operation of the network and downstream consumer security of supply. The detail of this will be unique to each region and will only become visible during the RIIO-3 period as asset transfer becomes clearer.

- **Supporting a just transition.** Any transition to decarbonise heat will have a significant impact on all our customers particularly the most vulnerable and those least likely to be able to transition to alternative decarbonised solutions. As such it is essential to understand and evaluate as early as possible the different transition pathways for our customers regardless of the fuel they migrate to, and to establish ahead of time how to support them on that pathway and to help inform the work of the regional energy strategic planner (RESP). Other aspects of a Just Transition need to focus on skills and jobs, where the transfer of workforce talent in a shift from fossil energy to renewables can be facilitated and supported, and where upskilling is necessary prior to final policy decisions to ensure that policy-outcomes can be promptly and securely implemented.
- **Opportunities to repurpose.** The most obvious repurpose of the gas distribution networks would be to distribute hydrogen, the main constituent of town gas that the networks distributed prior to the conversion to natural gas. In the event that the network is deenergised, the concept of repurposing the gas networks to alternative uses in the event that it is no longer required is clearly attractive, the practical challenges of actually delivering this, however, are significant. As a result, the value potential should not be over-estimated and likely to be a fraction of its current baseline value as a gas transportation asset. Therefore, the opportunity to explore repurposing activities and understand how the value can be maximised should be considered in RIIO-3. It will be important, therefore, that

RIIO-3 funding is allocated to enable alternative uses to be explored and evaluated from both technical and commercial perspectives.

- 4.15. It is important that this work is funded in RIIO-3 to support the decarbonisation of heat decision and recognising that if there is a change in Government the decision may be delayed, or new questions are asked. It is important that Government should have the most accurate information for their decision and that as networks we should support them in that. Given the short road map to securing net-zero, it is unlikely that this work would otherwise be completed within government targets, or that a third party other than the network operator would have the competency, knowledge, and expertise of the network to undertake this work efficiently and securely.
- 4.16. Whilst the Heat Policy decision from the UK government in 2026 will influence the role of the network, there may also be unintended consequences of other policy decisions from UK and devolved governments that could be legislated before or during RIIO-3. These could have a material impact on the operation of the network as consumers are mandated to make choices through the enactment of new laws such as those proposed in the Scottish governments Heat in Buildings Bill. The outcomes of these will have a bearing on a wide range of consumers across the energy networks, and RIIO-3 needs to have appropriate funding mechanisms for networks to be able to react accordingly to support policy objectives.
- 4.17. The activities listed above are justified and should be funded to maintain plausible options for the decarbonisation of heat, these are also aligned with Ofgem's case for change within section 12.9 of the SSMC Overview Document. This would also support the low regrets principles for re-purposing the gas networks (and therefore appropriately balances and protects the interests of existing and future consumers) and detailed next steps for potential transition to hydrogen for industrial decarbonisation or deliver resilience for alternative solutions that may be used to meet current ambitions of clean power by 2035 and net zero.
- 4.18. Inclusion of such funding is therefore important to achieve the objective (para 4.4 of the SSMC Overview) of managing the strategic uncertainties around the future of gas networks and ensuring efficiency in future investment.

**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?**

- 4.19. **We agree with Ofgem's proposal that network costs associated with blending at both distribution and transmission level should be funded through RIIO-3 uncertainty mechanisms and consider many of the existing structures to be appropriate for facilitating this. We have set out examples of projects that we would anticipated may be required in RIIO-3 under each of the mechanisms according to the stage of their technological and commercial development cycle.**
- 4.20. There are a variety of net zero related uncertainty mechanisms that are currently available and could be deployed in RIIO-3 these include;
- Network innovation allowance (NIA),
  - Strategic innovation fund (SIF),
  - Net Zero and Reopener Development Fund Use it or lose it (NZARD UIOLI),
  - Net zero pre-construction work and small net zero project reopener,
  - Net zero reopener; and
  - Price control deliverables for the roll out of technology.
- 4.21. From our perspective each of these has a distinct purpose according to the stage of project development.

- The NIA and the SIF are most appropriate for the early-stage innovative projects that will support the deployment of novel approaches and technologies that improve blending through improved control systems, metering, odourisation, gas agitation, energy content sensors and contingency systems. They are however constrained by requirements for innovation rather than deployment.
- The NZARD UIOLI mechanism is more appropriate for the actual deployment of technology and moving technology from late stages innovation through to commercial deployment and delivery, as NIA and SIF do not typically cover this. It is our view that the NZARD UIOLI is the suitable mechanism as we look to integrate hydrogen blending into our networks which will require the development transient models for our below 7bar networks to ensure the operability of the network to facilitate hydrogen blending activities is not compromised.
- The 'net zero pre-construction work and small net zero project reopener' is more appropriate once a technology is established and if the cost of deployment is significant then it may be beyond the scope of the NZARD UIOLI and therefore such a reopener may be better to use to fund more significant expenditure and roll-out of equipment. An example of technology that may require the 'net zero pre-construction work and small net zero project reopener' would be the investment decarbonisation of SIUs by converting them to biomethane.
- The Net zero Reopener is appropriate when it comes to the delivery of technology which is established, of material value and where the uncertainty surrounding the needs case was too high at the time of business plan submission.
- Price control deliverables for the roll-out of technology is appropriate where a technology is clearly identifiable at the start of the price control, it may also be possible to assign it to a PCD. In RIIO-2 SGN had PCDs to cover remote pressure management, biomethane improved access roll-out, gas escape reduction toolkits. It is our view that these PCDs have maintained the right balance of deliverability, transparency, and funding for the deployment of nearly established technologies at the start of the price control rather than waiting for the next reopener window. In RIIO-2 we had strong support from stakeholders to progress with this approach, early signs in Ofgem SSMC Working Groups and from our Internal Stakeholder Group are that this support remains and should be retained but with additional flexibility i.e., options to widen the scope and make the PCD's available to all networks in order to increase the benefits to all customers and not be seen as a regional lottery.

- 4.22. When considering these funding mechanisms, it is important that the funding should not be artificially constrained or sized according to customer base. From a regional perspective we look to utilise funding to ensure that the connection opportunity is maximised and can deliver under a regional strategy across locations. As an example, in the instance of Scotland, curtailed wind offers a significant opportunity for producers and connections, and this opportunity should be maximised.

**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)?**

- 4.23. **There will be a requirement during the RIIO-3 period to ensure flexibility and responsiveness to manage the uncertainty surrounding the use of hydrogen for heating. It will be critical to work closely with the RESP and NESO to progress toward net zero, and key to this will be engaging with customers and stakeholders - industrial, commercial, and domestic. It is essential that this work is appropriately funded, and we believe that the funding mechanisms that are available in RIIO-2, set out in our response to OVQ3, provide an appropriate base for RIIO-3.**
- 4.24. Our investment over the RIIO-3 period to advance the energy system transition will rely on continued funding of R&D, whole system planning and address the priorities of net zero at a national and regional

level, to ensure we can be responsive to emerging needs, evidence, support and to be able to facilitate decarbonisation and whole system solutions on the back of policy decisions.

- 4.25. Over RIIO-3 we will continue the delivery of credible early pipeline routing for the transportation of hydrogen at a regional level, ensuring a fully connected hydrogen system across our network areas. The interaction of the energy networks with local area energy planning and the development of whole system solutions will form the basis for investment through regional studies, and early development work to understand the whole energy system impact of decarbonisation. These will align with the role of the Regional Energy Strategic Planners (RESP) under the National Energy System Operator (NESO). As we progress further towards net zero during RIIO-3 it will be critical to work closely with the relevant actors to deliver plans, programmes of work and the tools to ensure a cost effective and efficient delivery of energy for all consumers. Key to this will be engagement with customers and stakeholders across the various sectors such as industry, power and transport and engagement with devolved government and Local and Regional Authorities.
- 4.26. Regardless of the policy decision outcome in 2026 a range of activities for networks will need to be developed depending on the pathway taken by government on the role of hydrogen in a domestic setting. In all scenarios, there will be a significant impact on consumers, some of whom will be in vulnerable situations. Having the appropriate care and safeguards in place for those who need it most is critical throughout the transition to net zero. The funding mechanisms in the RIIO-3 period should incorporate, as they did for RIIO-2, a defined benefit to consumers to alleviate the financial constraints and impacts of the transition to net zero across the energy system.
- 4.27. It is our view that most of this work should initially be funded through the Net Zero and Reopener Development Fund Use It or Lose It (NZARD UIOLI). However, projects will develop and other funding approaches (as set out OVQ3) need to remain available when projects require levels of funding over and above that of the NZARD UIOLI, such as those anticipated for full FEED studies around new hydrogen pipelines or activities associated with repurposing parts of our network where a Heat Policy re-opener would be appropriate.
- 4.28. It is therefore essential to have the necessary funding mechanisms and flexibility in place to ensure networks can fully respond to strategic decisions, and the impact these will have on existing and future gas consumers.

#### 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?

- 4.29. **We disagree with the proposal not to fund further evidence relating to the repurposing of the existing network for hydrogen prior to the hydrogen heat policy decision in 2026. Such a decision would send a very negative signal to the market, reduce the options available to the UK economy to decarbonise heat, and would risk locking the UK into a higher cost and less socially acceptable decarbonisation pathway. Until there is a clear pathway which is led by customer demand to appropriately balance and promote fairness between current and future customers interests in the journey to decarbonise domestic and industrial heat, all options should continue to be developed at pace.**
- 4.30. The gas networks have been working closely with DESNZ and the HSE over the RIIO-2 period under the Hydrogen Programme, to deliver the evidence to aid government in their Heat Policy decision around the role of hydrogen in domestic heating. Whilst a large body of evidence will have been delivered to DESNZ in RIIO-2 there may still be a requirement to instigated evidentiary work prior to the Heat Policy decision being announced.

- 4.31. DESNZ noted this was an iterative process and that they may have to assess, reassess, and submit further evidence leading up to the future decision. This opportunity will be removed if the appropriate funding mechanisms are not available from the start of RIIO-3 to the point of the decision being taken. The lack of funding would be inconsistent with government policy and the ambition of equipping government to make informed decisions on hydrogen.
- 4.32. Examples of such work include;
- **Trials and testing to support the evidence base.** There will be a requirement to fund additional work with ongoing trials that may roll over into RIIO-3 or require additional development work, such as our H100 Fife project, LTS Futures and Multiple Occupancy Buildings, specifically the decarbonisation of high rise and high-risk buildings. These are key areas to understand the role hydrogen can play in meeting net zero.  
  
These critical projects will require additional support during the interim period from the start of RIIO-3 and the Heat Policy decision being made, utilising the proposed RIIO-3 funding mechanisms. As an example, further demonstration of additional operational activities with the LTS, such as in-line inspections and pipeline repair methods, along with investigation and testing of network installation components such as PIG traps and valves would deliver additional evidence.  
  
Further full-scale testing on vintage pipe material, including fracture toughness testing to assist in understanding the differences between the transportation of natural gas and hydrogen. Understanding such phenomena and the development of relevant standards would bring repurposing of the LTS to a Technology Readiness Level 9.
  - **Technical verification and validation of our operating models.** This will include the training, tools and equipment, and internal policy frameworks, which are crucial enabling activities that will be required to facilitate the transportation of hydrogen. With plans already in progress for the repurposed network to provide hydrogen to industrial and commercial consumers, this, along with developing digital solutions for hydrogen network data need to be delivered irrespective of the Heat Policy decision in 2026 for domestic heat.
- 4.33. Whilst we are fully supportive of a full and complete heat policy decision in 2026, it is important to recognise that the actual decision may be postponed or may be a partial decision subject to more evidence. It is SGN's view that there is a high likelihood of a limited or delayed decision due to a potential change of government at the next election and an incoming government may have different questions that they require answers to.
- 4.34. It is SGN's view that a delay to the decision is made all the more likely given the market evidence of customers reluctance to adopt heat pumps as a replacement to their current gas heating system with just over 12,845 low carbon boiler upgrade voucher redemption requests received in 2023, of which approximately a half were to come off gas<sup>30</sup> so approximately 6,000 a year. SGN's network alone has 6 million customers. Given the lack of a decarbonisation solution that is accepted and willingly adopted by customer, it is important to keep options open and to maintain support in informing a decision.
- 4.35. Furthermore, it is important to recognise that there is a very high level of overlap between the work that needs to be completed to enable the roll out hydrogen as there is to enable the de-energisation of the network. As a result, a lot of the challenges being addressed are common and independent of the direction that any decision takes.
- 4.36. If the proposal '*to not enable further funding*' was implemented, this would have a very negative impact on our ability to provide the evidence base required by government and would risk the enabling activities that will be required to facilitate the transportation of hydrogen to provide hydrogen to industrial and commercial consumers irrespective of the Heat policy decision 2026.

<sup>30</sup> <https://www.gov.uk/government/statistics/boiler-upgrade-scheme-statistics-december-2023>

- 4.37. Secondly if the decision ‘*to not enable further funding*’ was implemented, and the decision was taken at a later date to remobilise research, there would be significant additional costs associated with restarting and remobilising the research community and third-party innovators, a risk of duplicating work as programmes resurrects, and significant delays as research facilities re-establish themselves and resource in an appropriate manner.
- 4.38. Finally, if the decision is ‘*to not enable further funding*’, this would significantly undermine the confidence and constrain the potential for delivery of any hydrogen heating decision in advance of the government’s own decision-making process and in this there is a significant risk that this policy would reduce the options available to the UK to deliver net zero and risk locking the UK into a higher cost decarbonisation pathway. Inclusion of such funding is therefore important to achieve the objective (para 4.4 of the SSMC Overview) of managing the strategic uncertainties around the future of gas networks and ensuring efficiency in future investment.
- 4.39. Given the risk of delay set out above, the interactions with the hydrogen transport business model set out in question 1, the reluctance of customer to adopt heat pumps, and the current lack of a clear customer pathway to decarbonise heat, we think it is premature to rule out any options that may enable us to deliver the 2050 net zero commitments. As a results, we would not support the statement in para 4.10 of the SSMC that “*would not expect to fund work where the benefits are contingent on hydrogen heating ahead of government decisions in this area in 2026*”.

**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?**

- 4.40. **As it stands there is insufficient evidence to establish the appropriate course of action for decommissioning costs. The current assessments have identified a broad range of uncertainty around the costs which is to be expected given the technical requirements of de-energisation and decommissioning of the network is still very poorly understood, particularly at the level of the distribution network. There are also significant social and welfare implications, particularly for the most vulnerable customers, which would need to be considered before any conclusion can be reached.**
- 4.41. **RIIO-3 provides the timely opportunity to progress the evidence base on which to assess options and their impacts, however, before any anticipatory funding is implemented, we think that there needs to be evidence led assessment as to the plausibility of the FES scenarios to ensure that current consumers are not paying unnecessarily or overpaying for scenarios that may not materialise.**
- 4.42. Recovering the cost of decommissioning will be a complex challenge that will have significant social welfare implications and inter-generational cost implications. For these reasons, we think that it is important to have a clearly defined pathway to decarbonise heat that is demonstrably acceptable to the majority of customers in the UK before committing to any action on managing the associated costs of decommissioning. We should however continue to explore and understand the nature of the issue and the challenges that we will need to address.
- 4.43. The Arup report<sup>31</sup> identified a broad range of uncertainty around the costs of deenergising and decommissioning the gas network. It is evident that at the time that any costs of decommissioning are incurred there will be no customers remaining on the network, and therefore there will be no route for direct cost recovery from the customer.

<sup>31</sup> Future of Great Britain’s Gas Networks Report for NIC and Ofgem. ARUP <https://nic.org.uk/app/uploads/Arup-Future-of-UK-Gas-Networks-18-October-2023.pdf>



- 4.44. There are a variety of options for addressing this which include building a fund in advance though charges to customers whilst they are connected to the network, through recovering costs across all energy customers or recovering costs from central government. With 74% of households having gas central heating as the only source of heat<sup>32</sup>, there are complex social considerations to these different cost recovery options.
- 4.45. Introducing a decommissioning fund upfront will have potential welfare implications, if those with the financial capacity to upgrade the insulation and the heating system in their homes to switch to an alternative low carbon heating technology will do so to avoid such decommissioning fund payments. Those with unsuitable housing to accommodate alternative low carbon heating solutions, or without the funds or legal right to make the necessary investments in their (or their landlords) properties, would have to pay for the decommissioning of a greater proportion of the assets.
- 4.46. There is an equivalent fairness challenge from recovering the cost of decommissioning across all energy consumers or the taxpayer, with 17% of customers having non natural gas inputs as their sole source of heat (i.e., electrical, tanked, or bottled gas, communal heating, renewable or biomass).
- 4.47. The social consequences of allocating decommissioning costs need to be considered fully, as a part of a technical and policy appraisal. Alongside the social outcomes, we need to consider the probability of incurring decommissioning costs according to the likelihood of different decarbonisation pathways materialising. Until there is a credible customer pathway that enables the majority of customers in the UK to transfer to an alternative source of heat in a politically acceptable manner, it will be hard to establish a robust scenario against which future decommissioning costs should be recovered.
- 4.48. As such it is our view that the cost implication of declining gas demand, decarbonisation and decommissioning needs must be considered holistically and the consequences fully assessed, balancing the social impacts of customer groups and the impact on current and future customers. As such we do not consider there to be sufficient evidence to respond within this consultation.
- 4.49. We fully support a detailed assessment of the options, debate, and impact analysis on different customer groupings from decommissioning activities. Following an assessment, if it is determined a fund is appropriate, then we would support the introduction of a levy through the billing structures.

## 5. SGN's response to questions within SSMC Section 5. Role of Scenarios and Planning Pathways

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

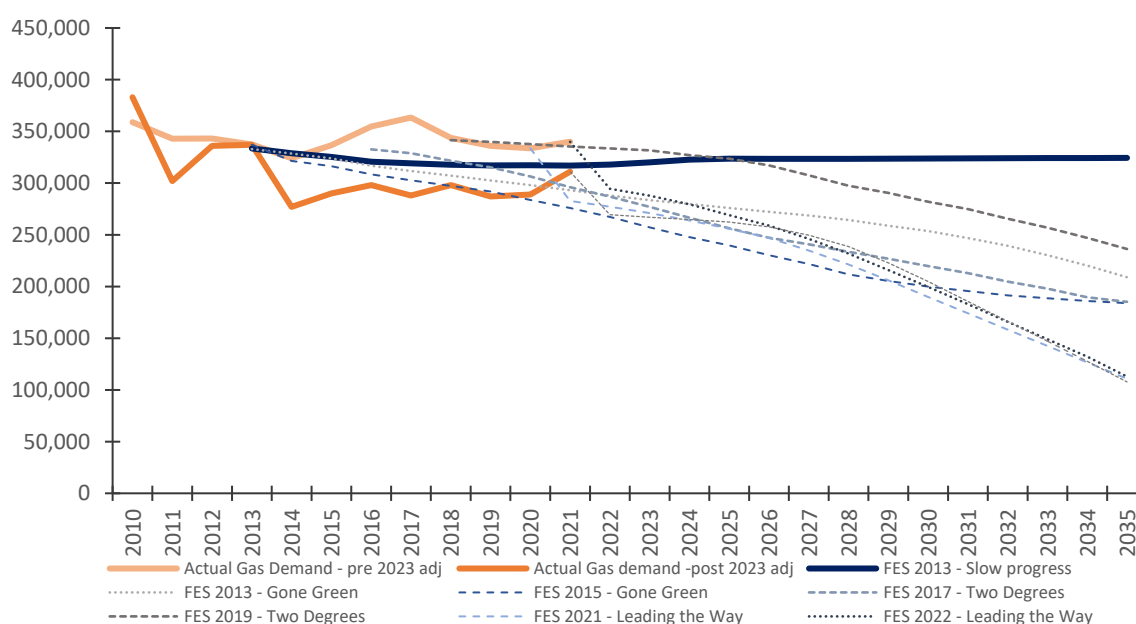
- 5.1. **We disagree with the proposal to use of the FES framework for selecting the RIIO-3 scenarios as they do not represent the investment decisions that need to be made by gas networks during the RIIO-3 period and market evidence does not suggest that the FES scenarios are robust. Investments by gas networks is driven by an absolute requirement to maintain safety and reliability within our network. By using the FES scenarios, we risk undermining investment required for safety, undermining investment required for security of supply, distorting the bill implications of network proposals and undermining financeability.**

<sup>32</sup> 2021 census - <https://www.ons.gov.uk/datasets/TS046/editions/2021/versions/1#get-data>



- 5.2. We do not believe the use of scenarios is suitable for RIIO-3 planning purposes, specifically as they are not forecasts; they are scenarios. As such, there are significant embedded assumptions about how policy makers would like consumers to behave in order to reach net zero by 2050 and the measures that policy makers would like them to implement that are not based on evidence of actual behaviour.
- 5.3. As an example, the current observed installation rates of heat pumps<sup>33</sup> are only 17% of the installation rate forecast for 2023 under 'falling short' scenario and 8% of the installation rate forecast under their 'leading the way' scenario. To reach 'leading the way's forecast position at the start of RIIO-3 there would need to be a 46-fold increase in the installation rate. Considering these forecasts were made in 2022, and they are already so far out, it calls into question the credibility of any of the FES scenarios for investment planning purposes.
- 5.4. Investment should not be made on this basis of such scenarios until there is clear evidence that assumptions underpinning such scenarios are likely to be realised. Rather, investments should be made on the basis of evidence available today and forecasts based on that evidence.
- 5.5. Figure 3 shows historical residential gas demand (as reported by FES<sup>34</sup>) against the most optimistic scenario in every 2nd year of publication dating back to 2013. We have then compared actual demand as reported by FES against the different scenarios. It should be noted that in the 2023 FES scenarios there was an adjustment to historical gas demand figures, as such we have shown historical data both before and after the adjustment to maintain comparability with the original 2013 forecast.

**Figure 3: Historical FES scenarios**



- 5.6. What is noticeably clear from these graphs is that, to date, the most accurate forecast appears to be the 2013 slow progress. As such we have no confidence that future forecasts will be any more reliable.
- 5.7. In terms of the impacts of using the different scenarios it is important to differentiate between implications of using FES scenarios on the assessment of capital investments, operational costs, and customer bills.
- **Capital investment.** These are investment proposals that we expect to present as a part of our business plan and are almost entirely independent of future energy scenario utilised. Our capital

<sup>33</sup> SGN calculation from BUS statistics - <https://www.gov.uk/government/statistics/boiler-upgrade-scheme-statistics-december-2023>

<sup>34</sup> SGN calculations on archive FES data books, 2013, 2015, 2017, 2019, 2021 and 2023 available <https://www.nationalgrideso.com/future-energy/future-energy-scenarios/documents>

investment proposals will be driven by the need to maintain a safe and reliable network for our customers domestic, commercial, and industrial customers. In our response to the FSNR consultation<sup>35</sup> we categorised investment requirements according to 'core' investment that were driven by the need to maintain safety and resilience of supply, 'core with options' investment where the investment is required but there may be trade off in the type of investment and 'pathway dependent options'. This demonstrated that very few investment decisions today would be impacted by the choice of FES scenario. For gas networks, the majority of our investment is driven by safety and resilience 'core' investment requirements. Therefore, whilst we support the 2050 net zero objectives, we do not consider the FES scenarios to be pertinent to our investment decision planning.

- **Operational costs.** The operational cost implications of the FES scenarios from a network operating cost perspective as with capital investment are largely scenario independent. We would expect the number of public reported gas escapes to remain due to the maintenance of gas within the network (there may be some reduction from in home escapes) and the ongoing maintenance and operating costs will remain broadly constant.

If imposed, the FES decisions may drive investment towards a shorter-term repair rather than a longer-term replacement option which would increase operating costs over the long term as a result of repeated repairs with the associated increase in disruption, risk, and methane emissions.

**Customer bill implications.** If the FES scenarios for customer numbers are used then it risks a significant distortion to the customer bill, particularly as there is no evidence that gives confidence that the customers will behave in the manner proposed by the FES scenarios by significantly increasing gas bills for and artificially suppressing electricity bill forecasts increase. Such bill impacts could lead to challenges in demonstrating the financial resilience of gas networks and requiring additional measures to be put in place to maintain financial resilience based on a scenario with a limited evidentiary support.

The second implication concerns the ability of our customers to plan ahead and for suppliers to secure resilient supplies. The uncertainty that is created by focusing on scenarios that are not credible introduces risk and security of supply risk for the domestic and the industrial and commercial customers that use our network along with the embedded generators that maintain the resilience of the electricity system. By running down the gas network before the electricity network has established the capacity to take the additional load puts at risk the whole-systems energy resilience and security of the UK.

- 5.8. Consideration should also be made on how the choice of FES scenario could influence key cost modelling drivers. While regardless of scenario our costs will likely remain similar, key exogenous drivers such as customer numbers and throughput could have significant variations if fixed against a FES scenario. Adding further complexity there are also regional differences to these exogenous drivers that could be exasperated if they are adopted, with potentially greater movement under FES scenarios for the Southern and Scottish regions.
- 5.9. Whilst we should be using all the tools available to understand the appropriate direction of travel, and then plan for a successful outcome (and network company involvement in Ofgem initiatives such as FES remains vital), our view is any RIIO-3 plans must incorporate GDNs forecasts within the analysis as they are demonstrably more accurate assessment of the GDNs demand requirements during the price control period than FES which is demonstrated in Figure 3.
- 5.10. If we look to address this from an alternative perspective and recognising the extreme scale of gas demand reduction proposed under the FES scenarios, we could consider what would be required to deliver a reduction in investment under the 'leading the way' scenario which has an 85% reduction in consumer gas demand by 2040 or under 'consumer transformation' which has an 80% reduction in

<sup>35</sup> 19.05.23 – SGN response to FSNR Consultation Ofgem Confidential.pdf, pg. 28.

consumer gas demand. For us to reduce our investment in line with either 'leading the way' or 'consumer transformation' we would require;

1. Clear knowledge as to which customers were going to come off the network.
2. A grouping of those customers in prescribed areas (i.e., zonal switch over).
3. Removal of obligations in licence and law to serve those customers and deliver to their peak demand.
4. Legal right to enforce a cut over if the customer determined not to switch.
5. Legal protection should there be a change in policy.
6. Absolute clarity on how networks will recover the full cost.

- 5.11. It is our view that the policy environment necessary to implement this is not currently in place, and we would not be supportive of such changes until there is clear pathway to decarbonise heat that is acceptable to the majority of our customers, and there is a demonstrable customer appetite to embrace that solution. Currently, we do not see any evidence for a clear customer choice other than status-quo. We therefore consider that using FES framework to select RIIO-3 scenarios is likely to result in an outcome that is inconsistent with evidence of customer demand, and which would undermine networks' ability to securely meet all reasonable demand for gas and to finance those activities.

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

- 5.12. **There is a significant risk that FES 'Leading the Way' will not be realised, and as a result, whilst we support the objectives of delivering net zero by 2050 and recognise the requirement to invest ahead of need, we also recognise that this may lead to over-investment. We need to have strong confidence that the need will materialise, and appropriate leading indicators and checks should be in place to ensure investment commitments are evidence based rather than aspirational scenario based. As identified in OVQ7, the assessment of the bill impact should not be based on Leading the Way until there is evidence of customers behaviours changing in the manner anticipated by FES.**
- 5.13. The UK's energy system should look to achieve successful decarbonisation in line with the 2050 targets whilst recognising that there is a risk that the policy objectives will not be delivered, and customer may be reluctant to move from gas heating to alternatives. As such, the energy system must be adequately resourced and planned to ensure both potential outcomes are able to deliver security of supply across the systems.
- 5.14. Electricity networks will need to invest to be able to support decarbonisation. It makes sense to inform the required investment by utilising all available assessments of those potentially suitable pathways which show how best to achieve net zero, which includes FES. An optimistic FES net-zero scenario, such as Leading the Way, might be an appropriate indicator as to how the electricity networks might need to develop and expand in support of the UK's net-zero aspirations. However, it is important to ensure correct investment is made in the electricity networks to both avoid them becoming a constraining factor in the UK meeting its decarbonisation ambitions and to avoid the over investment if alternative pathways look to likely to be realised.
- 5.15. To reduce the risk of over or under investment, we think it is important to have clearly defined and monitored leading indicators on key variables scenarios (such as heat pump deployment rates and EV uptake rates). This will help to determine the likelihood of a scenario being realised or not and the taper the level of investment accordingly.
- 5.16. Given the level of optimism in the FES leading the way scenario regarding customers' willingness to migrate it is very important to agree how customer bills should be presented. There is a risk that an overly optimistic or pessimistic customer transition expectation will artificially suppress the bill impact of

a proposed business plan and risks misleading to both the public and policy makers. We would suggest that any bill impact assessment includes a no-change assumption to provide consistency and transparency.

- 5.17. Finally, while planning to deliver the most ambitious scenario can be useful, Ofgem should ensure this does not come at a price that is too high, too soon. An overly optimistic transition may increase investability risk, signally to investors to finance ET based projects earlier than otherwise necessary, putting greater strain on gas networks maintaining a safe and reliable network as the backstop for customers within GB.

### 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?

- 5.18. **As set out in the response to OVQ7 investment in the gas network is driven by the need to maintain safety and resilience of the gas network. The FES scenarios give a view on customer demand and customer numbers and how they may change to deliver net zero. As a gas network we must invest according to safety. Even if the change in numbers presented by FES was plausible it would have negligible impact on the investment proposals presented. As such, we disagree with the appropriateness of using the FES scenarios as a relevant point of reference for the gas networks in RIIO-3.**
- 5.19. In our response to OVQ7 we referred to SGN's response to the FSNR consultation<sup>36</sup> where we categorised investment requirements according to 'core' investment, 'core with options' and 'pathway dependent options'.
- 5.20. For gas networks, investment is largely driven by core investment; namely, the continuation of the iron mains replacement programme, the replacement of assets that fall below a defined action-risk threshold and require replacement and maintaining our emergency service standards for responding to and repairing a gas escape. These are essential safety related expenditure requirements.
- 5.21. Within our FSNR consultation response we identified 'core with options' cost categories such as investments in local transmission system and the non-HSE mandatory distribution assets. For each of these assets there will be a decision on whether to repair, refurbish, replace, or rebuild an asset. Repairing or refurbishing an asset will be a shorter-term solution and as a result the associated operating costs will be higher; replacing or rebuilding an asset will be a longer-term solution with lower short term operating costs.
- 5.22. Currently, the decision between the two is determined by whether the costs and benefits of either replacing or rebuilding an asset is outweighed by the costs and benefits of either repairing or refurbishing an asset. This CBA (cost benefit analysis) takes place over a 16-year period, therefore, costs and benefits from the start of RIIO-3 will continue through to 2042.
- 5.23. A 16-year CBA would take an investment in 2026 (operational in 2027) through to 2042. During this period sum-of-digits depreciation would have depreciated almost 60% of the asset value. A 25-year CBA would be more appropriate and would take us out to 2051 by which time nearly 80% of the asset value would have depreciated. The value at risk is therefore the probability of that specific asset being de-energised by 2051 multiplied by the remaining value.

<sup>36</sup> 19.05.23 – SGN response to FSNR Consultation Ofgem Confidential.pdf, page 28

- 5.24. As we set out in our response to OVQ7, policy today does not favour mandatory cut-offs of consumer from the gas network. On this basis, we see no reason to have confidence that we can de-energise any component of the network before 2050.
- 5.25. The decision would only differ if there was confidence that, within that 16-year periods, all customers had migrated away from all downstream assets from that point of intervention and that there was a cheaper alternative which maintained safety. As the assets under consideration are typically larger tier parts of the network (i.e., tier 2, tier 3, or local transmission assets) a very high level of confidence is needed to meet this threshold.
- 5.26. By artificially, constraining the payback period it will encourage networks to undertake more repair or refurbishment work rather than replacement or rebuild work. This will increase costs to consumers unnecessarily by introducing higher operating costs over the long-term. Secondly, there would be an associated environmental impact of increase methane emissions from not replacing the asset, and lower safety benefit associated arising from a more short-term decision.
- 5.27. 'Pathway dependent options' do exist however, they are typically independent of customer demand across the network and focused on areas of customer and stakeholder ambition, such as the biomethane deployment or electric vehicles.
- 5.28. Accordingly, we do not agree with any of the FES scenarios being an effective point of reference in the investment decisions that we must undertake. Utilising FES scenarios is likely to result in an outcome that is inconsistent with evidence of customer demand, and which would undermine networks' ability to securely meet all reasonable demand for gas and to finance those activities.
- 5.29. Within OVQ7 we discussed the impact that FES scenarios may have on the cost drivers that are used as explanatory variables to determine efficient costs. As discussed, the forecast of costs is appears disconnected from the FES scenario used yet, exogenous cost drivers such as customer numbers and throughput are greatly influenced by the FES scenario utilised. Furthermore, regional differences are likely to be exasperated using overly ambitious scenarios, such as Leading the Way. Due to this, the use of multiple scenarios adds extra uncertainty to the assessment of cost efficiency and should be avoided for gas networks.
- 5.30. It is our view that a common scenario should be based on an appropriate forecast of when customers are likely to disconnect from a given section of a network. Once the last customer from a section of network has disconnected (or has had disconnection imposed) then it is possible to de-energise that section of network and either make safe by filling with an inert gas or material or decommission entirely. Once there are reasonable assumptions for when this is likely to occur and in which network zones then it is plausible to establish meaningful scenario on levels of safety related investment.

### 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?

- 5.31. **Our previous responses to OVQ7 and OVQ8 which discuss our view of how the use of FES is inappropriate for planning purposes should be understood as part of our response to OVQ10 and could run contrary to GEMA's duty to maintain safety and security of supply. On this basis we think that a common gas network scenario should be driven by a forecast of when the last customer disconnects from a section of network and investment needs to be maintained until that point. Currently this is unknowable, and the market evidence and current policy position suggests it will not be for a considerable amount of time.**

- 5.32. With GEMA's duties to maintain the security of supply in the interests of existing and future customers in relation to gas conveyed through pipelines, it is very important that GEMA support the investment that enables the continuation of the conveyance under all scenarios and does not look to impede the security of supply by assuming a reduction of domestic demand until there is clear evidence that there is a decarbonisation pathway that is driven by and supported by customers demand.
- 5.33. The SSMC expresses concern about use falling short and whether this is credible given that FES 5-year forecast is significantly lower and in line with system transformation (para 5.21). Our concern is that the FES 5-year forecast is not credible given the assumptions that it has made about the willingness of customer to install heat pumps and reduce their comfort levels. As such it is certainly not a reasonable basis on which to base investment decisions that are necessary to protect customer safety and security of supply. As shown in our response to OVQ07 the FES forecasts have not been an effective basis on which to plan investment to-date and using them as a guide to the future is likely to be detrimental to current and future customers.
- 5.34. As set out above the investment that we are presenting in RIIO-3 is focused on maintaining safety and reliability of supply. These are points of considerations that under the Gas Act GEMA must have regard to.
- 5.35. It is important that Ofgem have a consistent perspective across gas networks on how safety and resilience of supply should be reflected. We therefore consider that the preservation of the emergency service to respond to and repair public reported gas escapes, the replacement of pipes identified as 'mandatory' by the HSE and the use of standard cost benefit techniques to establish whether a pipe should be repaired or replaced, are the appropriate core basis for planning investment during the RIIO-3 period.

### 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?

- 5.36. **Our view is that alternative FES scenarios is likely to have very limited impact on the investment decisions being undertaken, as the FES scenario are incompatible with the investment case that we need to make to maintain security of supply and safety. The updated FES scenarios, which we understand will move from 4 to 3 and remove "falling short" are likely to be even less compatible.**
- 5.37. Our previous responses to OVQ7, OVQ8, OVQ9 and OVQ10 discuss our view of how the use of FES is inappropriate for planning purposes should be understood as part of our response here.
- 5.38. In addition, our understanding is that FES 2024 will be delivered with a fundamental change to the structure of the outputs and, while the base analysis is to remain relatively similar, the structure of the outputs is to be significantly different, moving from the current 4 scenarios to 3 and that the equivalent to falling short will be removed. Basing investment decisions and business plans on such a scenario would not be compatible with the need to secure that reasonable gas demand is conveyed through pipes and that these activities can be financed.
- 5.39. As such we do not think that the FES scenarios are compatible with the investment case that we need to make to maintain security of supply and safety. We do not see any reason to anticipate the FES 2024 scenarios are likely to be any more compatible.



## 6. SGN's response to questions within SSMC Section 6. Outputs and Incentives

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

- 6.1. **Ofgem proposals for retaining both evaluative and mechanistic PCD's are welcome, as is the proposal that the networks should look to reduce any regulatory burden associated with them. It is our view that PCDs provide for an appropriate level of transparency particularly for where costs are excluded from the cost benchmarking methodology and for supporting the roll-out of ambitious and novel projects supported by our customers and stakeholders. Where a PCD is related to an uncertainty mechanism, however, it is important that the costs are appropriately allocated to minimise the risk of perverse incentives through incorrectly defined unit costs.**
- 6.2. PCDs within RIIO-2 are a safe measure of ensuring that allowances allocated for the delivery of specific activities or projects could be automatically returned to consumers if those projects were no longer required or were delivered to a materially different specification. It is our view that they bring transparency and confidence to the price control settlement process. We set out below specific considerations on the 1) the definition of PCDs - Materiality thresholds, and programmes of work, 2) the application of PCDs to innovation projects and uncertainty mechanisms and 3) changes to PCDs in either the timing of delivery or the scope of work.
- 6.3. Definition of PCDs
- PCDs and materiality thresholds.** Whilst we recognise the benefits of a materiality threshold, it needs to be set at a level that is appropriate to the investment being undertaken. In gas distribution networks the majority of projects will be driven by the need to improve the safety and reliability of the network. As a result, projects tend to be smaller than other sectors that are expecting a significant expansion of capacity. Given that projects are driven by safety requirements, that the consequence of failure is assessed within the NARMs model through a CBA approach, and the NARMs output is not reflected as a driver within the cost assessment calculation It SGN's view that an appropriate threshold would be £2m. for specific projects and that this provides the appropriate point of separation between ongoing maintenance and integrity work which is common across all networks, and specific safety related interventions. SGN also consider that this supports a level of transparency for customers and supports confidence that networks are delivering the projects that they requested.
- Having a threshold much greater than £2m significantly increases the risk of a poorly calibrated price control if there is not an appropriate driver within the regression model through which those costs can be assessed and compared. Without a driver in the regression model, then it is the frontier company that sets the amount of investment in a particular cost category, and that may not be appropriate for the geographical characteristics of the network or the requests of customers and stakeholders.
- PCDs and Programmes of work.** When considering the threshold, it is important to consider the definition of a 'project' or 'programme of work' and to ensure that there is consistency across networks. In RIIO-2 we observed inconsistencies in how programmes of work were defined. As a result, some networks identified programmes of work which were subject to technical assessment, which other networks did not separate out and their costs were subject to benchmarking. It is SGN's view that a programme of work should be considered as a *'collection of projects, often across multiple sites within a network, where the work activity is broadly similar.'*
- 6.4. The application of PCDs
- PCDs and innovation projects.** Within the SSMC, Ofgem propose that rolling out or commercialising innovation projects on a larger scale (para 6.42) could be achieved by submitting bespoke outputs and justifying the technical assessment of such projects. Whilst this is an option, it is our view that this



misses an opportunity to support knowledge sharing and information dissemination and an opportunity for transparency and demonstrating value. SGN would propose to keep innovation PCDs. As we set out in our example below there are important lessons from the rolling out of innovation that are beneficial for all industry to be aware of and learn from to maximise the benefits of previous innovation funding.

**Example - SGN Bespoke PCD – Remote Pressure Management.** A good example of the benefit of a PCD structure is the SGN PCD on remote pressure management. In this instance the cost of deploying an innovative technology increased significantly from initial estimates set out in business plan submission in 2019. This increase was largely driven by the need to improve the design so that it could be deployed to a greater variety of real-world applications and was less bespoke to the test environment used for the trial. We were able to discuss the changes with Ofgem and agree an alternative approach in a transparent manner and can document the associated learnings. By including this type of project in baseline allowances we are concerned firstly that 1) innovations may not get deployed fully if they are assessed through benchmarking methodologies and they lack an appropriate cost driver, and 2) the learning benefits of this process and the applicability of the innovation to other networks may be reduced.

- **PCDs and Uncertainty Mechanisms (UM).** We agree with Ofgem's suggestion that PCDs should continue to be attached to reopeners where appropriate (para 6.44). It is our view that this can support confidence in delivery and enable the effective stage gating of projects where there are critical dependencies (such on the planning system, or feasibility work).
- **Evaluative and mechanistic PCDs.** In para 6.37 to 6.39 the SSMC sets out the differences between mechanistic and evaluative PCDs. We agree with this distinction, and that mechanistic PCDs should be defined according to the volumes and unit costs of deliverables. We note however that a mechanistic PCD is effectively a volume driver and can be expressed as such within the licence which would support simplification. As such we support limiting PCDs to evaluative and move all mechanistic PCDs to a volume driver.

Where a mechanistic PCD, or a volume driver, is defined it is very important that appropriate consideration is given to the unit costs that are attributed to them. In RIIO-2 we found values that are produced through the regression model costs were often distorted by the regression outcomes and bore limited resemblance to the costs submitted in the business plan or had inconsistencies in cost. A poorly calibrated cost driver rewarding over/under delivery can distort the incentive properties of a mechanistic PCD or volume driver by either encouraging or discouraging networks to perform works if unit rates are set incorrectly.

Attention should also be given to deliverables governed by a mechanistic PCD, or a volume driver, where the unit costs have a high proportion of fixed to variable costs. If there is a high proportion of fixed costs included within the volume unit cost, then there is a risk of incentivising over-delivery or unduly penalising under-delivery. In both these instances an incorrectly calibrated £/unit measure can distort the incentive properties of the PCD or volume driver.

Increased use of specific engineering technical assessments should be utilised to define costs within PCDs and volume drivers, rather than risk being overly reliant upon efficiency scores from totex modelling that can be influenced by factors outside the space of the specific PCD. This is similar to the challenge that NPG recently brought to the CMA regarding disaggregation of allowances and highlights the importance of defining this allocation of allowances appropriately between non-variant and variant allowances. We discuss this further within GDQ64.

## 6.5. Changes to PCDs

- **PCDs and delays to delivery.** We agree that companies should not benefit from delays in delivery or non-delivery. One of the benefits of the PCD structure is that it provides confidence that the funds will be fully repaid in the event of non-delivery. In the instance of a delay to delivery, then very often

it is the result of factors that are outside of the control of the network (such as planning, or policy factors), and it is already a sign that the project is more likely to be more expensive than originally forecast. Accordingly, whilst we agree that companies should not benefit from delays in delivery, we also need to provide sufficient flexibility that delivery delays should not be penalised by default (for example should the delivery of an output extend across price control periods).

- **PCDs and changes to scope.** We agree with the objective of balancing delivery and enabling flexibility, and in these instances, it is important to recognise that objectives and the most optimal outcome may change during a price control period. On this basis we would support an evaluative PCD also having scope to change the scope in a manner that enhances consumer benefit.

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

- 6.6. **We agree with Ofgem's proposal to continue the financial incentivisation of companies, we recognise the desire for network companies to work together and the collaborative street works incentive is a good example of this. We also need to recognise that customer expectations continue to evolve, and incentives provide an effective incentive to keep pace with these expectations. We continue to have concerns about an over reliance on penalty-based incentives and the use of dynamic incentives.**
- 6.7. Output Delivery Incentives (ODI's) are utilised to good effect in order to incentivise network companies to improve the delivery of services within specific areas that are important to customers and stakeholders. It is our view that they are most appropriately deployed when the regulator wants to support positive change.
- 6.8. Financial ODI's are of particular importance when Ofgem require delivery from network companies to be set higher than normal standards. SGN has seen this approach deliver better results for customers and stakeholders and provides additional focus to priority areas for delivering change in business practices or delivering to an improving standard.
- 6.9. It is our view that incentive based ODI-F are more effective in promoting change than penalty base ODI-F. We are concerned that that a penalty based ODI becomes reactionary and as a result behaviours and performance improvements are primarily considered when there is a risk of breach, by which point it is too late to implement meaningful change. A financial incentive, however, sets a challenge for managers to respond to and be incentivised against driving positive change through the organisation.
- 6.10. Similarly, we continue to disagree that dynamic targets provide an appropriate way for incentivising networks. By their very nature networks are limited to the geographical region in which they operate, their customer characteristics and the assets themselves. Accounting for these factors in to create a dynamic target that does not discriminate against networks according to their geographical characteristics is very challenging. We also believe that it reduces the benefits of collaboration between networks, which we consider to be in customer interests.
- 6.11. The sector methodology consultation emphasises the increase importance of co-ordination between gas and electricity network companies and the potential for more scope for that encourage network companies to co-ordinate with each other for better customer outcomes. We agree that this has significant potential, and in our response to OVQ15 on bespoke outputs we give the example of the collaborative street works incentive which SGN proposed as a bespoke incentive at the outset to RIIO-2 and has since become very successful.
- 6.12. We believe that the reason this incentive has been successful in supporting collaboration, was because there was a specific need that was identified, that was strongly supported by local government (the GLA),

where the benefits were measurable, and there were significant barriers (cost and administrative) that reduced the likelihood of projects taking place without such an incentive being in place.

- 6.13. It is important that these attributes are maintained when considering incentives for co-ordination between gas and electricity networks. Where the output cannot be sufficiently defined then a more qualitative approach such as that utilised by the Stakeholder Engagement Incentive during RIIO-1 should be adopted; this will require detailed design.

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

- 6.14. **We agree with the proposed retention of reputational incentives and consider that they have an important role to support internal and external focus on a specific topic. However, they need to be used sparingly, with a clearly defined scope that is of relevance to the consumers as the reporting burden associated with them is significant.**
- 6.15. We are concerned that within RIIO-2 the reporting burden on network companies has increased significantly and we are not convinced that the additional reporting is providing significant additional value to either Ofgem or to our customers.
- 6.16. On this basis we would welcome a review of the reputation incentives to confirm whether they add value to either Ofgem or our customers. The Fuel Poor Network Extension ODI-R is an example of an ODI-R where the customer and stakeholder expectations are developed since the business plan was developed and are no longer aligned with the expectations that were in place at the start. The Business Carbon Footprint ODI-R is an example where it can be combined with the Environmental Action Plan / Annual Environmental Report ODI-R.

As we progress through the licence drafting it is also important to scrutinise where reporting obligations are placed on networks which are not listed as ODI-Rs and are produced on a regular basis. There is a cost associated with producing these reports and their appropriateness should be considered.

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

- 6.17. **We agree with the desire to minimise the number of bespoke incentives and agree in principle that customer should have a similar level of service, however, we also recognise that some geographical regions have strong local policies, and it is right that networks should look to support them and be incentivised to do so if that brings about a business change.**
- 6.18. A good example of a successful bespoke output is the collaborative roadworks incentive. This was put forward by SGN for our South London region in the RIIO-2 business plan. The proposal was strongly supported by the GLA and extended to cover Cadent who operate in North London. As we progress through electricity and water, it looks as though the incentive is being extended, or has been extended, to those additional utilities.
- 6.19. We consider this to be a very good example of how an initial bespoke incentive can be broadened to other networks either within the same price control or within future price controls and we hope that it provides a template which other regions can adopt.

- 6.20. Given this example, and the positive customer outcomes it has generated, we think it is appropriate that companies should be encouraged to recommend and develop incentives that deliver consumer benefits and can be broadened out to other networks.

## Cross Sectoral Outputs - Environmental Action Plans

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

- 6.21. **We agree with Ofgem's underlying principle that network companies should look to further minimise their impact on the environment and improving transparency of networks actions and progression in line with the targets set out within the environmental action plan. We believe that PCDs provide an important role in ensuring that funded commitments are delivered for customers and networks are transparent in their delivery or account for non-delivery.**
- 6.22. We agree with Ofgem's proposal to retain EAPs and AERs in RIIO-3. Transparency is important and requested by shareholders, investors, and other stakeholders. As set out in the SSMC in RIIO-2 Ofgem set out minimum requirements for companies to adopt (para 6.115) however we note that in RIIO-2, the minimum requirements were set out late in the process, this made it difficult to accommodate the expectations and created divergence between network companies plans. We support the proposal to adopt a similar approach in RIIO-3 (para 6.121) and encourage early and joint development of expectations and early publication of minimum standards. This will support transparency and consistency.

### Use of PCDs

- 6.23. We support the maintenance of PCDs for environmental initiatives that the network companies put forward in their EAPs. Specific PCDs provide a focus on deliverability, and associated accountability for projects that look to progress ambition and respond to stakeholder and customer expectations. The PCD structure also provides clarity in funding which is to the benefit of customers and network companies.
- 6.24. We note that the SSMC proposes a minimum threshold is applied to the use of PCDs. We recognise the objective of reducing the administrative complexity of the licence and we agree in principle that deliverability can be monitored and assessed effectively through the independent stakeholder engagement group (ISG). The SGN ISG (previously referred to as the customer and stakeholder engagement group (CSEG)) has operated throughout RIIO-2 and is supported by an environmental advisory panel, the panel meets regularly and reports to a board committee (Stakeholder & ESG Committee). This provides a robust level of scrutiny on environmental uses. Our understanding is the different networks took different approaches on whether to retain an independent Customer Engagement Groups over the RIIO-2 period and as a result may have varying levels of scrutiny.
- 6.25. If PCDs are not used, it is very important that the funding mechanism is clearly defined. The EAP is a good example of where there is no appropriate driver defined within the benchmarking model, i.e., there is nothing that calibrates outputs delivered and expenditure required to deliver those outputs. If for example, a network responds to stakeholder and customer feedback to have ambitious EAP outputs, the costs necessary to deliver these ambitious outputs will be presented as an inefficiency in the benchmarking model and removed. This then creates a misalignment between customer expectations and funding provided and confusion on the commitment made.
- 6.26. As a result, it is very important that EAP costs should be removed from the benchmarking model and technically assessed in terms of whether they provide a well evidence and efficient costs base and funded accordingly, rather than through the benchmarking process. Not to do so will undermine the level of ambition that network companies are prepared to present.

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

- 6.27. **We support Ofgem’s proposal of being transparent and reporting on what actions we are taking to improve our environmental impacts, including progress against targets. It is important that these reports should align as far as possible with other reporting standards to reduce the reporting burden, and KPIs should be focused on relevant metrics that show improvements against a clear objective or target.**
- 6.28. Since the business plan guidance for RIIO-2 was issued, the environment & sustainability landscape has changed. Stakeholders including shareholders, investors, and even new potential talent that companies wish to recruit, are increasingly expecting to see evidence of how organisations act responsibly from not just an environmental perspective, but also socially and ethically. Publishing and demonstrating ambitious ESG (environment, social and governance) commitments are becoming the norm.
- 6.29. We therefore suggest that any Ofgem guidance or common reporting format is kept simple. Lengthy, complicated, and too descriptive guidance usually results in more confusion, and places undue burden on organisations in terms of resources to complete the reporting.
- 6.30. Key KPIs should be aligned with other reporting standards and need to be relevant and material to the organisation. KPIs should also be linked to a target towards which it would show progress. Great examples are carbon emissions scope 1 and 2 (both including and excluding shrinkage) progress towards medium and long term emission reduction targets, amount of waste generated, recycled, and reused towards relevant waste targets etc.
- 6.31. There should be an ability for networks to have the AER commentary and KPIs as annexes of a wider sustainability & ESG reporting if they so desire. This would reduce the amount of reporting required by a company and aid the general stakeholder in finding what they need.
- 6.32. We support the proposals to strengthen AER reporting standards to improve consistency across network companies. In this we need to keep in mind that there are levels of consistency, within Sector (i.e., across GDNs) is the most important, across sectors (i.e., across ED and GDNs) is valuable but should not be at the expense of the quality of the KPI as an accurate indicator of performance.
- 6.33. As an example, we note Ofgem’s aim to ensure that network companies consider biodiversity and the climate crisis in new construction and mitigate environmental impacts prior to construction. The word “new construction” requires definition to avoid confusion and provide consistency. For SGN we would define this as construction of new pipelines, networks, or above ground installations, and not reinforcement, replacement, or maintenance of existing assets. In this context we would consider the new legislation on Biodiversity Net Gain if applicable and ensure the long-term operational resilience of the asset in the light of climate-related risk.

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

- 6.34. **We support Ofgem’s proposal for retaining the reputational incentive on TOs and GDNs for reducing their business carbon footprint (BCF). It is important to agree an approach to shrinkage and leakage whilst a verifiable Science Based Targets methodology is being developed for the oil and gas sector.**

- 6.35. Please note, however, that the statement in para 6.129 “*all three TOs and four GDNs adopted emission reduction targets that were independently assessed and verified by Science Based Target Initiative*” [SBTi] is incorrect. No GDN has been able to verify their BCF target with SBTi.
- 6.36. Firstly, the science-based methodology for oil & gas sector is not yet available, and it is not expected to be available until the second half of 2024. In the meantime, SBTi does not accept targets submitted for verification by a company in the oil & gas sector.
- 6.37. Secondly, targets set by the GDNs (in alignment with Ofgem’s RIIO-2 guidance) excluded shrinkage. It is not expected that SBTi would verify an emissions reduction target which excludes shrinkage as this makes up a significant part of a GDNs carbon footprint.
- 6.38. Shrinkage is part of scope 1, as the GDNs own the network (owned and controlled source). The definition of BCF, according to para 6.128, is scope 1, 2 and 3 emissions. Hence this includes shrinkage unless specifically expressed shrinkage should be excluded.
- 6.39. Due to the importance of shrinkage on a GDNs carbon emissions, it qualifies for an emissions reduction target. This would benefit society (mitigation of climate change) and the environment. In addition, scope 1 and 2 emissions excluding shrinkage, justifies its own target, not to be overshadowed by the much larger shrinkage element. Therefore, we are supportive of maintaining an ODI-R for scope 1 and 2 emissions excluding shrinkage.
- 6.40. Scope 3 emissions can also be considered for an emissions reduction target and should be in the short – medium term. It would require a robust process to collect material scope 3 data to enable the setting of a baseline, and subsequently a target. SGN is not able to set a scope 3 emissions reduction target as yet due to the complex nature of scope 3 emissions.
- 6.41. Scope 2 can be reported as ‘market based’ or ‘location based’. We would recommend the use of the ‘location based’ approach as this would show and drive tangible climate action (e.g., installation of direct feed solar PV at an office), rather than ‘market based’ which only entails paying for “green electricity” from the grid.

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

- 6.42. **We support proposals that keep the reporting as simple as possible and as closely aligned to existing and emerging reporting standards as possible to reduce the reporting burden placed on networks, reduce confusion, and to deliver comparability with sectors that are not regulated by Ofgem.**
- 6.43. Keeping it simple and aligning as much as possible with existing (for example SECR, GRI - Global Reporting Initiative) and emerging standards (ISSB) with the application of the same (relevant!) metrics and KPIs as these frameworks prescribe. SECR requires an organisation to report on scope 1 and 2 emissions and are currently consulting on scope 3 emissions to be included in reporting going forward.
- 6.44. As many companies provide a set of reports for interested stakeholders already, there should be an ability for networks to have the AER commentary and KPIs as annexes of a wider sustainability & ESG reporting if they so desire. This would reduce the amount of reporting required by a company and aid the general stakeholder in finding what they need.

#### 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.

- 6.45. **We agree with Ofgem's minded -to position overall, however, in RIIO-2 the environmental score card was only applied to a limited number of customers. It is our view that as a financial incentive it does not seem to have a strong sector or geographical specificity. As such, the change that Ofgem are looking to implement is broadly consistent across all networks and it should therefore be broadened to all networks if it is going to be continued to provide a level of consistency. However, it is important that this does not duplicate information in the AER.**
- 6.46. In RIIO-2 the Environmental Scorecard was not applicable to GDNs, and we do not have the experience or knowledge to comment on its suitability and proposal to withdraw. We agree with having less documents, plans, and scorecards to follow up against; hence the EAP should be the main document describing how to mitigate environmental impacts and set out targets and commitments, and the AER (or equivalent reporting) is the document following-up on progress on achieving such targets and commitments. It is our view that a consistent financial incentive across ET, GT and GD would be beneficial in driving improvements.

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

- 6.47. **We believe that there is a benefit associated with incentivising network companies to deliver to a higher environmental standard and a financial incentive will motivate greater improvements than a reputation incentive in isolation.**
- 6.48. We believe that the AER (or equivalent reporting) is the document following-up on progress on achieving such targets and commitments. It is our view that a consistent financial incentive across ET, GT and GD would be beneficial in driving improvements across the board.

## Cross Sectoral Outputs - NARMs

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

- 6.49. **We broadly support Ofgem's proposals for the framework's direction and working towards a long-term monetised risk measure for RIIO-3. However, we have concerns on the potential funding adjustments set out in the NARMs handbook, the burden of the annual reporting requirements, and expanding the coverage of NARMs beyond the existing asset groups.**
- 6.50. We support the movement to adopt long-term monetised risk measure for RIIO-3 and are making the necessary adaptations to offer a long-term view of investments. This adaptation will enable GDNs to transition from single-year risk assessments to long-term risk-benefit measures for RIIO-3. In our response below we discuss the NARMs Funding Adjustment and Penalty Mechanism framework, the NARM reporting requirement, and extending the role of NARMs.
- NARMs Funding Adjustment and Penalty Mechanism**
- 6.51. While the NARM Handbook offers valuable guidance on the mechanism's principles, we share significant concerns that the methodology for the NARMs Funding Adjustment and Penalty Mechanism remains incomplete. Undefined elements, such as the "Clearly Identifiable Over/Under-Delivery" threshold, generate uncertainty around the final allowance for the RIIO-2 close-out.



- 6.52. We support the clawback and penalty associated with unjustified under-delivery, but the mechanism requires thorough testing to ensure it effectively accounts for asset management practices. This testing must be finalised before the commencement of RIIO-3 price control. Further discussions are necessary to refine the mechanism fully before it is applied to RIIO-3 outputs.

#### **NARMs Reporting**

- 6.53. Although the SSMC currently does not address the NARMs Regulatory Reporting Pack (RRP), we firmly believe it warrants review for RIIO-3. The current annual reporting process is time-consuming, and with limited feedback, the use of RRP data for performance analysis remains unclear.
- 6.54. While we recognise that certain data within the RRP template is necessary for effective performance monitoring and network company accountability, some proposed data requirements seem excessive and deviate from the intended purpose. These data-capturing exercises offer minimal value to consumers and Ofgem.
- 6.55. We advocate for prioritising the development of NARMs models to align with asset management practices, enabling companies to make informed investment decisions. We are willing to work closely with Ofgem to find a balanced approach between accountability for companies' investment and reporting requirements.

#### **Expanding NARMs Coverage and Expenditure Linked Output**

- 6.56. Given that the long-term risk element is still undergoing development, we propose limiting NARMs to the existing asset classes defined in the current methodology. Our current focus is on successfully implementing and aligning the long-term risk element with the asset management practices. Therefore, introducing additional gas or non-gas assets at this stage could compromise the quality of existing work.
- 6.57. We further believe that expenditure thresholds/rules for assets within NARMs should be pre-defined within the SSMC (e.g., projects exceeding £5m ring-fenced into A3). This would allow for consistent assessment across companies and facilitate alignment of cost and risk elements.
- 6.58. We firmly believe that addressing these concerns will result in a robust and effective NARMs framework for RIIO-3. We remain committed to working with Ofgem to achieve this outcome through the consultation workshop.

## **Cross Sectoral Outputs – Climate Resilience**

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

- 6.59. **We agree with the need for more proactive engagement on climate change resilience and we broadly agree with the principles that are set out and the establishment of a 'climate resilience' working group. Given the unique characteristics of the individual networks and the different ways in which the climate resilience risk is realised we think that it is important that this group considers gas and electricity assets separately but linked through common principles. We also consider that there could be a rationale for including climate change resilience within the NARMs methodology, however, we need to consider carefully how this would be realised in practice given the range of uncertainty and highly geographical nature of the climate related risk.**
- 6.60. Through-out RIIO-1 and RIIO-2 we have seen an increasing incidence of direct weather-related impacts on our network, including but not limited to fluvial erosion events where heavy rainfall has washed away the ground cover around buried assets, through ground heave and subsidence, etc. These incidents are highly correlated to the level of rainfall within a specific region as such the framework through which the risks are assessed needs to be carefully considered.
- 6.61. Key considerations are that;

- The need for a common approach and common data set to ensure the whole industry is using the same forward-looking data. This is important to allow for consistency across networks and it should be recognised that identifying and developing forward looking data and metrics may require third party support. There is an opportunity to learn and build on the approach taken in RIIO-ED2.
- The common approach should be to clarify the extent to which secondary impacts of climate change resilience should be considered. For example, the loss of electricity, or other supply chain disruption, due to weather related disruption can be as impactful as a direct weather event.
- The approach to climate-resilience needs to be joined up across all GDNs and will need to consider that climate-resilience working groups need to collaborate beyond the gas distribution networks, including local councils and other stakeholders (such as the Environment Agency), to improve resilience and reduce the impact of events.
- Improving climate resilience and taking a more proactive approach will require funding both to enable the functionality to incorporate the climate resilience information and in terms of the measures that can be taken to improve resilience.
- Inclusion of climate resilience within the NARMS model should co-exist with a re-opener or Use-it-or-loose-it allowance to manage any climate related incidents when they do occur.

- 6.62. The SSMC sets out four principle (para 6.157), subject to the points set out above we agree that (1) decisions should be based on forward looking data; (2) that high impact and low probability events are likely to become more common; and (3) that costs and benefits of adaptation need to be correctly valued.
- 6.63. The fourth principle states *“investment decisions need to be fit for purpose for the decarbonised energy system”*. We would like this to be clarified, it is our view that the primary objective is to ensure safety and security of supply. Climate related events can threaten both and investment decisions are needed to protect safety and security of supply during extreme weather periods; this is in line with GEMA’s principal objective to protect the interests of existing and future customers, in terms of the security of supply of gas and the protecting the public from dangers arising from the conveyance of gas.

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

- 6.64. **Gas networks have demonstrated a very high level of network resilience and reliability with network reliability for SGN being over the last 3 years being 99.995%. This resilience supports the continued used of gas networks for securely delivering hydrogen and green gas. Recent storms have shown how damaging intense rainfall can be, however, there are significant challenges of forecasting exposure to weather related events. Increasingly we are considering secondary resilience impacts associated with the extended outages of telecoms or electricity.**
- 6.65. Gas does not fail safe, and as such we have high levels of resilience, the consequences of poor resilience are that much greater, and the risks need to be considered much more carefully. The high levels of resilience of the gas supply are one of the benefits it provides for security of supply and transporting green gases as a part of the net zero energy mix.
- 6.66. The second consequence of a high level of inherent resilience is that it can then be a challenge to identify where the weaknesses are within the system that may be exposed. In the last 5 years these have been driven by river erosion events that were caused by high levels of rainfall across the catchment areas. We are increasingly thinking about secondary resilience impacts because of extended outages in electricity supply or telecoms.
- 6.67. As an example, Storm Babet<sup>37</sup> (18<sup>th</sup> – 21<sup>st</sup> October 2023) was an intense 1-in-100 year storm which caused extensive damage and flooding across the Northeast of Scotland. The river South Esk was particularly impacted, and it carved a new channel approximately 80 meters away from the southern bank. There were 29 river crossings in the area of the ‘red weather’ warning and 121 crossings in the

<sup>37</sup> [https://www.metoffice.gov.uk/binaries/content/assets/metofficegovuk/pdf/weather/learn-about/uk-past-events/interesting/2023/2023\\_08\\_storm\\_babet.pdf](https://www.metoffice.gov.uk/binaries/content/assets/metofficegovuk/pdf/weather/learn-about/uk-past-events/interesting/2023/2023_08_storm_babet.pdf)

‘amber’ weather warning zone. Whilst we have not completed a full assessment of all the crossing yet (many are still inaccessible) it is likely that there are large proportion that will require remedial work to be carried out and it may be that pipes will require a full diversion.

- 6.68. A second example is in August 2020 a period of intensive rainfall in North Scotland between the 11<sup>th</sup> and 12<sup>th</sup> of August saw approximately 1 month rainfall within a 3-hour window<sup>38</sup>, exposing a 70m section of high-pressure pipe. There were significant safety implications associated with this and cutting the supply would have caused a major outage to twelve thousand customers. As can be seen from the picture below, the asset was a significant distance from the river, and predicting and monetising the probability of this occurring in a meaningful way would have been particularly challenging.



- 6.69. Both examples are evidence of how quickly changes are happening due to our changing climate. They focus attention on the extreme and difficult to anticipate impacts of extreme weather events and the need to consider the vulnerability of an asset in relation to its specific geographical attributes. This will be challenging to robustly reflect within the NARMs methodology.
- 6.70. Secondly these examples call into question what should be considered a ‘safe distance’ from a riverbank or similar geographical feature, and the costs of relocating an asset to be further away and the level of reliance that should be placed on short-term measures (such as shoring up the riverbank with rocks).
- 6.71. Both examples show that it is crucial to have the flexibility and ability to adapt quickly to changing circumstances. They also focus attention on the extent to which responding to an event requires collaboration across all utilities and other key stakeholders.
- 6.72. A continuation of the diversions re-opener within RIIO-3 should enable us to respond to changing circumstances, but consideration should also be made to have specific reporting within both the BPDts and the RRPts to highlight specifically the costs relating to climate resilience. This would be consistent with the reporting requirements within the ED sector, which includes specific tables for flood mitigation and environmental reporting.

**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?**

- 6.73. **We agree with the proposed approach, however, we are cautious about whether it will be possible to embed climate change resilience into RIIO-3 in a timely manner and whether it will materially change the decisions that are taken in the business planning process. On this basis we think that it is important**

<sup>38</sup> [https://www.metoffice.gov.uk/binaries/content/assets/metofficegovuk/pdf/weather/learn-about/uk-past-events/interesting/2020/2020\\_07\\_august\\_rain.pdf](https://www.metoffice.gov.uk/binaries/content/assets/metofficegovuk/pdf/weather/learn-about/uk-past-events/interesting/2020/2020_07_august_rain.pdf)

to maintain a reopener which enables applications for funding as the principles develop and that this reopener should cover both reactive and pro-active activities.

- 6.74. In principle we agree with the suggested approach although it is too early to be confident that the amount of time and resources necessary to integrate climate change resilience will be justified by alternative investment outcomes.
- 6.75. When we consider the examples provided in response to question OVQ24 there are limited options for protecting the asset apart from re-laying the asset in a less risky location either further away from the risk, laying them deeper, building resilience by introducing alternative bypass routes, or adding material to the surface of the asset (e.g., rock dumping). From our experience rock dumping only offers limited protection and can be undermined by another serious flooding event.
- 6.76. Whilst we are seeing a continued increase in climate related events within our networks, we think it is important to test whether the scale of costs necessary to implement enduring protection outweighs the probability weighted risk of an event occurring. Setting this out conceptually initially and then formalising the assessment process would be beneficial and will need to be considered separately for gas and electricity.
- 6.77. In recognition of these challenges that we consider it is important to maintain uncertainty mechanisms to allow network companies to respond after an event and in a quick and robust manner to ensure that we maintain a safe and reliable network.

## Cross Sectoral Outputs - Resilience Metric

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

- 6.78. **We agree that it is important to focus on resilience, we are not clear on what is implied by a resilience metric, and we are conscious that ‘climate resilience’ and associated roles and responsibilities can vary significantly according to stakeholder perception. We also need to recognise that networks are one part of a broader energy system, where resilience can be impacted from multiple interactions. Clarifying the scope, roles and responsibilities is an area that required collaborative development.**
- 6.79. We agree with the proposal to develop a resilience metric and note that this was originally set out by the NIC in their 2020 report<sup>39</sup> which was too late to be implemented prior to the start of RII0-2, however within our draft determination response we suggested that it should be implemented prior to RII0-3<sup>40</sup>.
- 6.80. It is our view that the ‘Anticipate, React, Recover’ provides a good framework through which the concept of resilience should be considered, and that through standards of service, our winter preparedness plans and our safety obligations we have many of the requirements in place, they are not necessarily brought together however into a single document.
- 6.81. On this basis we think that a resilience metric is sensible, and we should work towards a standardised resilience framework across gas distribution networks. This should clearly set out roles and responsibilities and where there are points of hand-over or interactions with other networks (such as telecoms, or electricity supply), critical supply chains (such as odorant provision) or other actors in the energy markets (such as suppliers or shippers).
- 6.82. As an example, in December 2022, our Scottish Network failed a standard of service – responding to a controlled gas escape within 2 hours of it report 97% of the time. Because Scotland is a small network relative to other GDNs in terms of customer numbers, however, due to the geographical sparsity it is exposed to significant workload swings and then has a limited opportunity to recover by averaging it out over the rest of the year. Between the 12<sup>th</sup> and the 15<sup>th</sup> of December 2022 an intense cold snap drove the number of calls to our emergency service number to 4.5 times the average call volume in the previous

<sup>39</sup> <https://nic.org.uk/app/uploads/Anticipate-React-Recover-28-May-2020.pdf>

<sup>40</sup> SGN Response to Draft Determination, 4<sup>th</sup> September 2020, answer to question GDQ14.

month. Our performance in the standard of service had been high 98%'s in the months preceding, during that four-day period we lost the standard of service and we then returned to 99.9% for the rest of the year. The majority of calls during that period were not associated with safety of the network, rather they were in-home measures such as frozen boiler condensate pipes and restricted supply response from other service providers on the emergency line.

- 6.83. This example demonstrates the breadth of impact that needs to be considered when looking at resilience, a consideration on what is the role of the network companies, an assessment of the cost associated with providing that role, and an assessment of how that role impact other service providers (3<sup>rd</sup> sector, local resilience, or competitive market players).

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

- 6.84. **We agree that workforce resilience is important and needs to be carefully managed. However recent experience demonstrates that workforce resilience is linked to factors that we can control (such as training) and factors that we cannot (COVID, Brexit, and competition from other sectors etc). We therefore agree that workforce resilience should not be an area of formal performance targets.**
- 6.85. We recognise the importance of our obligations to deliver a modern, diverse, high quality, well-trained workforce that is fit for the future. We are seeing increasing challenges in these areas that are being caused by both uncertainty around the gas sector as well as through various macroeconomic factors that impact the workforce (COVID, Brexit, cost of living pressures, competition from telecoms, water, electricity, and other large capital spend projects, particularly in the south).
- 6.86. The Southern part of the country has a particular supply constraint in labour resources that makes recruitment particularly challenging, and the levels of churn particularly high as our highly trained and skilled staff have an abundance of opportunity in other sectors. This has a direct impact on costs but as it takes up to six months to train an FCO and up to 2 years to train a repair teams leaders, it creates as significant additional cost, resource, and time requirement to replace them.
- 6.87. The same challenge is experience in availability and training of teams to complete repex work, whether through contractors or direct labour where it takes 2 years for a Service or Mains Layer to be trained to competence through an apprenticeship. The contrast between our Scotland and our Southern licence areas is stark, whilst workforce resilience and building skills is a challenge in all areas, in Scotland the main challenges are in the complex skill sets, and the changing demands placed on those skills (instrumentation engineers, cyber, etc). In Southern the scale of the challenge is fundamentally different and associated with our ability to compete for the resource necessary to do the work.
- 6.88. Accordingly, we agree with Ofgem on 'the increasing importance for network companies to deliver a modern, diverse, high quality and well-trained workforce fit for the future' (para 6.184). We also agree that this it would not be appropriate to set formal performance targets around this due to the highly localised nature of skills, the areas where shortages are likely to transpire and the price implications of signally overtly to the market of where skill shortages currently present a challenge.

## 7. SGN's response to questions within SSMC Section 7. Truth Telling and Efficiency Incentives

- 7.1. SGN believes in the concept of providing an incentive to enable companies to put forward consistent, deliverable, transparent and high-quality business plans. Linking this to efficiency incentives is also sensible, as it enables appropriate calibration of incentives aligned with when information provided is of high or low confidence.
- 7.2. The historic application of such incentives has been difficult in previous price controls, primarily around the lack of understanding and transparency about how the process occurs. This is lack of understanding has



been both within network companies and external stakeholders. If an incentive scheme is not targeted, simple, transparent, and implemented in a timely manner then it will be unsuccessful in its determined outputs.

- 7.3. We would welcome a process to develop the RIIO-2 framework as opposed to introducing new elements that may add further confusion over the application of any such incentives. Streamlining the current process would be a sensible approach to build on an already base level of understanding, specifically targeting on areas that lacked definition within the RIIO-2 process such as the concept of cost confidence.
- 7.4. To add new concepts late in the process for companies constructing their business plans will greatly dilute the effectiveness of the incentive.
- 7.5. In setting such business planning incentives Ofgem should also consider its intentions regarding cost assessment, as the data collated is used within the cost assessment process. If there are mechanisms within the cost assessment process that already incentivise companies to provide robust data, then consideration of this should be had. The setting of a business plan incentive scheme should not be conducted in isolation from the overall cost modelling approaches.
- 7.6. As we have worked within recent cross sector working groups, SGN are supportive to help streamline, refine, and better define the business plan and efficiency incentives within the RIIO-3 price control period. We would welcome early engagement on such areas to ensure they can be effectively understood ahead of any business plan submission.

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

- 7.7. **Whilst we recognise the objectives set out within the paragraphs 7.15 and 7.16 of the consultation overview document, we consider the term 'Truth Telling' to be inappropriate and pejorative. It is very important that business plans should be deliverable and that forecast costs should be a true reflection of expectations. It is not in the interest of current or future customers to set allowances at levels that are below the cost of delivery and therefore undeliverable in the same way that it is not in their interests to set too high and over-rewarded. We would advocate for a Business Plan Quality Incentive (BPQI) that promotes a consistent, deliverable, transparent and high quality business plan.**
- 7.8. As noted through recent cross sector working groups, we have challenged the naming of this mechanism, due to the connotation it implies companies do not put forward truthful forecasts. A more suitable term instead of 'Truth Telling' would be Business Plan Quality Incentive. Where quality of the information and justifications on both costs and deliverability should be considered and consistent with the purpose of the mechanism - to ensure companies put forward quality data that can aid Ofgem in the assessment of efficient costs and outputs. As such, we suggest this mechanism should be referred to as the Business Plan Quality Incentive (BPQI).
- 7.9. We would advocate that a BPQI should be;
  - **Consistent:** It should be consistent with the business plan guidance and the RIGs; networks companies should be encouraged to identify where there is a risk of inconsistency so that it can be addressed in an open and transparent manner at an early stage and discouraged from introducing inconsistencies.
  - **Deliverable:** Plans should be deliverable in terms of the both the workload and the anticipated costs. Where costs are expected to change from historical costs, changes should be justified, and evidence based. The networks should be encouraged to deliver higher quality evidence to support their submission.
  - **Transparent:** Plans should be transparent in the approach they have adopted and changes that are proposed in outputs and costs, alongside the assumptions made that may impact either. This transparency should extend to commitments that networks are proposing to go beyond the existing standards as supported by customers.

- **High Quality:** An efficient and high-quality business plan which is an efficiently costed plan with appropriate evidence to demonstrate its efficiency.

7.10. Ofgem's defining of the key principles of an incentive within para 7.17, being any incentive should be well targeted, simple, and transparent are particularly important. We would suggest that Ofgem also considers defining that a key principle of an incentive should be its ability to be attained as well as the attractiveness of any incentive. These are vital criterion to ensure that the design of any incentive program is successful, and a failing in any of the key principles will lead to an incentive scheme that is ineffective in its aim of delivering its objectives.

7.11. Paragraph 7.15 sets out three proposed objectives. As with the key principles of an incentive discussed previously, it would be helpful to set out more precisely what is meant by each of these objectives.

- 1) *'Business plan information that enables us to set the price control effectively'*. We understand this to mean that information should be provided in line with the business plan guidance, in line with the RIGs and in line with the guidance surrounding the BPD. Presenting data that is consistent and in line with the RIGs and Guidance supports consistency across networks should increase Ofgem's confidence that errors from input data are minimised. It is our view that this will be demonstrated by both the completeness of the data provided, the role played by the networks in identifying and resolving points of inconsistency, and the extent to which they support the regulator in providing data to support policy.
- 2) *'Ambitious cost forecasts'*. We would like to confirm our understanding that Ofgem considers an ambitious cost forecast to be one that is presented at a lowest cost. If this is the case then it creates an enhanced risk to deliverability, which is counter to Ofgem's RIIO-2 business plan guidance. Any incentive scheme should be calibrated to ensure the collection of high- quality information that can help Ofgem determine the efficiency frontier across the industry, for delivering key outputs. By setting an objective to put forward *'ambitious cost forecasts'* without an understanding of what this means and how it will be achieved it risks leading to perverse incentives, and unsustainable drive to the lowest possible cost. Underfunding is not in customers interests as essential investment on a safety critical asset such as gas needs to be funded appropriately. We would therefore suggest that the objective should instead refer to *'Efficient, high-quality cost forecasts that are deliverable'*.
- 3) *'Ambitious output proposals that go beyond baseline expectations'*. As with the second proposed objective it is unclear how this expression should be understood. Specifically, it is important to understand whether the proposed objective is (1) that licensees should deliver ambitions which are not funded within baseline allowances, or (2) whether the proposed objective is that licensees identify ambitious ways in which better customer outcomes can be delivered and higher quality evidence that supports for those proposals.

If the intention is to replicate the CVP then this should be clear from the outset.

7.12. Ofgem then set out their key two key objectives of the efficiency incentive (Para 7.16); 'incentivising efficient delivery of outputs in period' and 'sharing benefits/risks from out/underperformance in a way that contributes to addressing information asymmetry'. We would like to confirm that these objectives are in reference to the totex incentive mechanism (TIM) and in which case we think that the objective should be restated as 'incentivise efficient delivery of outputs and provide an appropriate balance of risk within a price control period'.

7.13. The second objective refers to the notion of 'information asymmetry' and we assume that this refers to the assumption that network companies have a significant information advantage over the regulator. We would like to draw attention to the volume of comparable data that Ofgem is able to gather on historical costs, the comparable forecast data, the amount of supporting information provided to Ofgem on all submissions and information gathering powers that Ofgem has available to it when it comes to scrutinising data.



- 7.14. On this basis we do not consider there to be a significant information asymmetry of information. Because Ofgem has access to such a significant volume of data they Ofgem can benefit from significant information asymmetries that are not available to the individual networks.
- 7.15. If we then consider the changes that have occurred since the start of the RIIO-2 price control period that is outside of the networks control which neither networks nor the regulator could predict – market volatility, a global pandemic, an energy crisis, supply side trade and labour constraints, supply shocks in the cost of steel and energy, and three different governments (potentially 4). The impact of volatility and the risk that this creates from a poorly calibrated regulatory mechanism is significantly greater. As a result, we are wary that all disconnects between forecasts and company performance will be interpreted to be ‘information asymmetry’, which would be incorrect. Increased volatility factors must be considered within the design and assessment of an incentive mechanism that reflects submitted data quality and the second objective should be restated as ‘reducing the impact of unanticipated changes by sharing benefits/risks from out/underperformance’.

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

- 7.16. **We agree in principle with Ofgem’s proposed approach to minimum requirements, however, we require greater clarity what constitutes minimum requirements, what the minimum requirements are expected to cover, and how they will be articulated. Having clearly defined minimum requirements is important to support transparency and comparability between plans.**
- 7.17. We welcome Ofgem’s proposal to reduce duplication and unrequired criteria, and we believe that it aligns with Ofgem’s ambition to streamline the approach adopted at RIIO-2. Similarly, we agree with many of the proposals presented<sup>41</sup> in the SSMC. It is very important that licensees have clarity as to the expectations that they will be required to meet at the earliest opportunity.
- 7.18. For this reason, we think that defining minimum requirements should be a collaborative exercise, with focus on defining the applicable standards and ensuring consistency of understanding – noting that oversimplification may reduce the consistency with which networks present information and inadvertently lead to breaches of Ofgem’s proposed minimum standards.
- 7.19. We note that the RIIO-ED2 minimum requirements evolved compared to the RIIO-2 approach and would welcome clarity from Ofgem on which set of minimum requirements they intend to be the starting position for any streamlining process.
- 7.20. Within the RIIO-ED2 process a particular improvement that was introduced by Ofgem was the requirement to complete the ‘Minimum Requirements Index Sheet’. This document is useful in clearly labelling where Ofgem expects a minimum requirement to be identified and explained. We would welcome this approach being included for the RIIO-3 minimum requirements, to ensure transparency on what requirements Ofgem requires companies to comply with.
- 7.21. One point of consideration when defining the minimum standards is how they will be demonstrated. With a 200-page limit on a business plan, multiple minimum standards encourage the use of appendices and supporting information to demonstrate that the minimum standards have been delivered on the basis that this business plan should focus on the ambition rather than the minimum standard. It is helpful to recognise this and consider how you would like the minimum standards to be evidenced.
- 7.22. Where penalties are considered, they should only be imposed for breaches of objective (as opposed to subjective) criteria. Ofwat’s requirement that information provided must be “sufficient and convincing” is inherently subjective unless significant time and effort is spent defining how ‘sufficient and convincing’ ought to be interpreted. This creates uncertainty around the basis on which one plan may be considered more or less ‘sufficient and convincing’ than another. As a result, we believe such an approach is likely to be more resource intensive and build unnecessary complexity into the process, so should be avoided.

<sup>41</sup> RIIO-3 sector specific methodology consultation – Overview Document. Para 7.23 pg. 78

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

- 7.23. **We agree in principle with the proposal that there should be greater clarity on how 'cost confidence' can be delivered for technically assessed projects that fall outside of the benchmarking process. Given the volatility in the market, and the limitations on the accuracy of the benchmarking models, the benchmark is not a robust basis to which to define a financial penalty for cost forecasts and such an approach would be duplicative with catch-up efficiency. An 'in the round' assessment would be inappropriate as such an approach would fail to appreciate cost challenges based on their own individual merit, a risk called out specifically by Ofgem within the SSMC.**
- 7.24. We have set out our reflections on the approach to cost confidence, cost justification and financial penalties, and in the round assessments below.
- Cost confidence**
- 7.25. Within RIIO-2 there was a lack of clear guidance on how to determine cost confidence, as well as inconsistencies in the application of cost confidence compared to other elements of the cost assessment process.
- 7.26. A key example of this lack of consistency would be a between the assessment of cost confidence of the Repex cost submissions, and the determination of outliers that occurred within the Repex Synthetic Cost model used to determine the cost driver for the Repex element of the single regression model. For the RIIO-2 BPI, all Repex costs were determined to be of high-cost confidence, because they either were able to be included within the regression modelling or were technically assessed. Yet within the Repex Synthetic Cost model around 4% of unit rates were omitted as outliers, implying that the cost confidence within the data was not as significant as determined for the BPI cost confidence.
- 7.27. Furthermore, SGN presented enhanced information on the basis that greater transparency and greater visibility of cost information would support greater cost confidence for technically assessed projects (i.e., those outside of the benchmarking model). In practice we found that it brought greater scrutiny and reduced perceived cost confidence due to a lack of consistency in the level of information put forward across companies.
- 7.28. It is for this reason that we think it is important for Ofgem to clarify early the level and type of information that is considered to support cost confidence and what information it considers to be unnecessary and unhelpful at the business plan stage. It would be helpful to have clarity on the data and engineering justification that should be provided and the approach that should be taken to considering risk and contingency according to the stage of the projects concerned.
- 7.29. Ofgem rightly is concerned about the regulatory burden this extra information may add, yet the process can be streamlined if there is clear guidance and a suitable template put forward early to submit the required information in a clear and consistent format. A 'self-certification' type approach could be utilised for cost confidence, where networks categorise each area of their plan by confidence dependent upon the quality of information that is within their business plan. If a common approach is agreed amongst networks, then the regulatory burden should reduce, and it would further aid data quality checks within the cost modelling suite and reduce duplication.
- 7.30. A further area where additional clarity would be useful is regarding the treatment of risk. It is our view that an assessment of risk and contingency is appropriate for all projects prior to signing contracts, and that a probability weighted cost should be applied in a transparent manner. This approach follows the methodology set out in the Treasury's Green Book and represents good practice project management more broadly. We note, however, that previous attempts to follow the Treasury Green Book guidance have been rejected, and no clear guidance has been provided on how risk and contingency should be taken into consideration, particularly for those projects at an earlier stage of the project development cycle. We think that this is another good example of where attempts to provide high quality and transparent justification of costs has been demonstrated not to align to Ofgem's expectations of 'cost confidence'.

### Cost justification and financial penalties

- 7.31. We note within para 7.25 there is a lack of clarity on the potential introduction of a financial penalty for cost forecasts that are high relative to the benchmark that is used to set allowances. This approach sounds similar to the stage 3 BPI that was utilised within RIIO-2 for low-cost confidence areas that did not have a cost justification. Yet it could be interpreted that a penalty will be introduced for all cost forecasts that exceed allowances, effectively introducing a double penalty. This would be of significant concern as it places an unwarranted level of confidence on the accuracy of the costs assessment process as well as significant implications to the overall financeability of any business plan proposal. We would request increased clarity on this approach within the SSMD.
- 7.32. At the submission of the RIIO-2 business plan, we forecast increases in repex costs that were disallowed through the benchmarking process. These costs have been realised, and probably underestimated. As a result, our perspective was closer to the truth than those networks that forecast reducing costs. Were the same situation to arise in RIIO-3, we would be penalised by not having those costs allowed and then further penalised by having an additional penalty applied.
- 7.33. Given the market volatility set out in our response to OVQ28 and continuing impact that these market changes will have on the RIIO-3 cost base coupled with the uncertainties in the accuracy of the cost assessment process that it would be inappropriate to set a separate penalty based on the same effective value of the already set catch-up efficiency challenge. This would further decrease the ability of companies to be able to 'catch up' to the frontier company and be a punitive penalty that would drive limited value. If the intention within para 7.25 was an approach akin to the RIIO-2 BPI stage 3 penalty, we would put forward that, as within RIIO-2, a key gate regarding any potential penalty would be cost justification. There are many viable reasons why a cost may be low confidence yet justified, such as for a Critical National Infrastructure project or complex Repex work with a low number of historic data points.
- 7.34. It is our view that given the uncertainties in the accuracy of the cost assessment process that any incentive should be limited to incentive only, rather than penalty, and that the financial incentive applied should be limited, in line with the confidence in the cost assessment approach and uncertainties in changes that will occur in the contractor and labour market over the next price control period, particularly for the more southern licence areas.

### In the round assessment

- 7.35. In para 7.26 Ofgem raise the possibility of an 'in the round' assessment. We would welcome greater clarity on how such an assessment would be undertaken and how an ambitious forecast would be distinguished from a cost forecast that lacks ambition.
- 7.36. It is our view networks, through areas outside of their control, are exposed to high levels of uncertainty regarding costs in RIIO-3, and it is important to have well evidenced and justified costs that are deliverable. We must also recognise that costs have become increasingly regional. The availability of labour to complete core workloads is highly geographically specific and across SGN's licences there is a stark difference between the cost pressures between Scotland and Southern England. An increasing cost forecast in Southern may be as economically justified as a flat cost forecast in Scotland, whilst an ambitious forecast in Southern may be to limit the rate of increase whilst in Scotland it may be to reduce overall costs.
- 7.37. Both positions can be economically accurate, and the Southern region should not be penalised for a 'lack of ambition' given prevailing economic expectations for which historic trend information is unlikely to represent reality.
- 7.38. For these reasons, it is our view that an 'in the round' assessment of costs would be inappropriate as it would fail to suitably appreciate cost challenges. Equally, the requirement for Ofgem to put forward a qualitative judgement is likely to increase the regulatory burden and fail in the key principle of an incentive scheme being transparent and attainable.

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

- 7.39. **We believe that the CVP can certainly be improved through the mechanisms that have been set out. This would provide greater clarity to networks and consumers as to the basis of the reward and would improve transparency on the reasons why a CVP is awarded. An 'in the round' assessment of CVPs would risk failing to recognise the individual unique merit of the CVPs put forward for our stakeholders.**
- 7.40. If Ofgem is minded to proceed with the CVP or a form of CVP, then the proposals set out in para 7.30<sup>42</sup> of the SSMC are positive developments that will support both comparability and transparency in how the award is to be made. This would be a significant step forward compared to the position of RIIO-2 where such clarity was not in place.
- 7.41. In addition to the points set out in para 7.30, we think that it is important that the methodology of calculating value, both economic and social value, and the methodology for demonstrating that customers support this, should also be set out clearly in the guidance.
- 7.42. The lessons learnt point of CVPs potentially causing a 'postcode lottery' effect is noted, but it should also be noted in many cases the CVPs put forward by networks and for activities that are unique to that particular network. There is a potential though to ensure there is a mechanism in place for networks to work more collaboratively to ensure any values that have been developed can be pushed to all networks if it is appropriate.
- 7.43. The alternative, as Ofgem points out (para 7.32), would be to develop an output proposal similar to that utilised by Ofwat in PR24. It is suggested that this approach is considered simpler to implement, however, we are not confident that this is the case as it creates a need for greater definition and clarification up front, and it requires that definition to then be applied to the assessment at the end. We believe this approach will work only if the detailed definition is provided in advance, and in good time for network companies to align their approach.
- 7.44. As, by definition, CVPs are consumer value driven, they are unique and specific in nature. An 'in the round' assessment approach risks comparing vastly different propositions that could inaccurately 'balance' out assessments, losing important clarity on decisions that are made by the regulator.
- 7.45. As set out above, we are very concerned about the use of a penalty regime in the business plan incentive structure when there is such ambiguity regarding the costs and deliverability going forward in the RIIO-3 period.

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

- 7.46. **We believe that the cap and collar of +/- 2% of the total price control settlement value is significantly in excess of what is reasonable and would not be in customers interests. In RIIO-2 for SGN this could have resulted in a reward or penalty of +/- £53m. Given the recent volatility and uncertainty surrounding future costs, such incentives levels risk networks over promising on cost efficiency benefits and then underdelivering. This would not be in consumers interests.**
- 7.47. It is currently very difficult to say what the size of any incentive should be as there is lack of clarity on design and expectations of the incentive / penalty regime.
- 7.48. Consideration needs to be given to the outcomes of the cost benchmarking approach if this is going to be used to define potential incentives / penalties. For example, the catch-up efficiency target that is used will impact the potential incentive a company could receive (a more challenging target would decrease the incentive). As such the attractiveness of such an incentive would diminish.

<sup>42</sup> RIIO-3 sector specific methodology consultation – Overview Document. Para 7.30 pg. 80

- 7.49. In RIIO-2 the frontier was moved from the 75<sup>th</sup> percentile to the 85<sup>th</sup> percentile, this increased the catch-up efficiency that was place on the majority of networks but reduced the size of potential incentive available to networks that exceeded the 85<sup>th</sup> percentile. As a result, the incentive properties need to be very carefully considered according to their interactions with the other components in the price control.
- 7.50. A further risk to incentive attractiveness could be the lack of normalising for scenario and age profile differences within modelling. A key area of concern within RIIO-2 for SGN was the differential of LTS related expenditure and how it was not considered within the cost driver used. SGN Southern was considered less efficient due to the age profile of assets that required replacement, which should have been controlled for within the modelling. Ofgem recognise that such differences and could be a penalty or incentive can be determined as much by the accuracy and sophistication of the benchmarking model as the when determining any potential incentive / penalties within RIIO-3 as it could diminish the size / strength of incentives unintentionally.
- 7.51. We do believe that companies should be both incentivised to put forward the best available data, and penalised if they fail to meet any reasonable standards set by Ofgem – but until it is better understood on what grounds Ofgem would be intending to assess quality data and forecast data, what minimum standards are set, and how the benchmarking approach and frontier position is going to be defined, we are unable to provide an opinion on what the size and strength of any ‘truth telling’ incentive should be.

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

- 7.52. **The RIIO-2 process applies a ratchet in that the lower of modelled costs vs submitted costs is utilised for setting allowances. A potential alternative approach to drive efficient costs could be to remove this ratchet, enabling a benefit to be derived through the cost assessment process directly. Whichever approach is chosen, as a point of process it is important that Ofgem makes this visible as early as possible to ensure it is effective as an incentive scheme to influence change within company's business plan submissions.**
- 7.53. As within the key principles put forward a good incentive should be transparent, well targeted, and simple. In reality this is unlikely to ever be achieved due to the complexity of the business plan being submitted and the macro differences across companies' structures and the challenging environment that gas networks are operating in (both policy and cost environment).
- 7.54. As such an incentive or penalty regime is likely to fail the key aspects of what would make it useful. Network companies are already incentivised to put forward the most ambitious costs proposals in order to perform well through the cost modelling suite, a pseudo form to introduce a competitive element amongst networks. Ofgem should consider removing the added complexity of running a stage 3 and stage 4 BPI and as the cost modelling process itself incentivises or penalises companies that according to their perceived efficiency or inefficiency.
- 7.55. There could still be a place for the stage 1 BPI in order to comply with minimum quality requirements and a stage 2 BPI to push companies to deliver more ambitious outputs for the benefits of their customers that is above and beyond the baseline.

### 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?

- 7.56. We would suggest that Ofgem should de-couple the setting of the sharing factors from the cost confidence approaches, and as such disagree with the three options that Ofgem propose to calculate the sharing factors. While cost confidence should be an important consideration when setting the sharing factors, there are further considerations including the wider regulatory regime and the financeability positioning. We note the setting of the TIM sharing factors is not required to complete the Business Plan guidance and can be determined later in the process.
- 7.57. As with other incentive rates and controls within the regulatory framework, the calibration of the Totex Incentive Mechanisms (TIM) sharing factor should be considered within the overall view of the regulatory package put forward.
- 7.58. This should include, but not be limited to:
- **The cost confidence of the submitted data.** If there is lower cost confidence in the business plan submitted data due to increased market volatility and the lack of historical information being a strong indicator for the future, then there should be a lower incentive rate for the sharing factor calculation.
  - **The interlinkages with other ODI-F.** The TIM sharing factor is also used within various other incentives to ensure consistency in the application of costs and incentives. The impacts to the attractiveness of wider incentives should be considered in setting the incentive rate for the sharing factor calculation.
  - **The impacts to financeability sensitivity modelling.** If companies are more exposed to underperformance against allowances, this can increase the materiality of sensitivity modelling within the financeability suite. Consideration of the impacts to financeability under different modelling scenarios should be considered, particularly for companies that require a greater 'catch-up' compared to reach the efficiency target set.
- 7.59. The TIM sharing factor is a very powerful incentive within the RIIO mechanism, touching all elements of the regulatory settlement. As such, it is paramount that the strength of such an incentive is set appropriately with consideration of the macro climate companies operate in and the regulatory settlement that is put forward.
- 7.60. At times of greater macro instability, to set a TIM sharing factor that can overly expose companies to extra funding requirements can cause a greater financial burden, and such implications should be tested before Final Determination. Simply setting the same TIM sharing rate as the RIIO-2 regime, ignoring interlinkages with the wider regulatory settlement, or setting a rate based upon qualitative assessment would fail to appreciate the implications of such a powerful incentive.
- 7.61. We would welcome further engagement with Ofgem on understanding how an appropriate TIM sharing factor could be set considering the risks and uncertainties that have occurred across the last 5 years and are likely to continue in the medium term.

## 8. SGN's response to questions within SSMC Section 8. Managing Uncertainty

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

- 8.1. **We agree that the retention of the Net Zero reopener as an appropriate mechanism for RIIO-3. It provides a suitable backstop for changes in government policy given the high levels of uncertainty.**
- 8.2. Given the uncertainty around the use of hydrogen for domestic heating resulting from the heat policy decision by the UK government in 2026, and the potential impact of other government policies as they become fully legislated both from the UK and devolved administrations, the impact could be substantial on the activities and investment required to be undertaken by network companies.
- 8.3. When considering the current licence condition,



- The net zero reopener is set alongside a price control deliverable. We are not convinced that a PCD in this context is necessary.
- The manner in which the reopener flows through the PCFM where there is a fixed capitalisation rate assumption, we think it is important that this should be variable according to the nature of the project (whether it is opex or capex).
- The funding provision is currently collected directly from the licence. It is our view that Ofgem should also have the power to direct other funding structures where it considers appropriate.
- We would like to confirm the formula in the licence is appropriate as it appears to be a 'subtraction' whilst it is our view that this could either be positive or negative.
- We would like to confirm that the real price effects and inflation are applied appropriately to the NZt term.

**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?**

- 8.4. **We agree it is appropriate to retain the Net Zero and Re-opener Development Fund UIOLI for RIIO-3 and should continue to be used to fund early development work for Hydrogen Pre-FEEDs and FEEDs as well as whole system themed projects. We believe it is premature to reach a conclusion on the interaction of the Net Zero Re-opener development Fund UIOLI with the HTBM and other funding mechanisms, the projects delivered under the Net Zero Re-opener development Fund UIOLI in RIIO-2 should continue whilst also progressing with other decarbonisation projects for GDN's.**
- 8.5. In RIIO-2 this fund has been used to deliver early development work through pre-FEED, FEED and regional whole system planning studies that align with Local Area Energy Plans and/or in Scotland Local Heat and Energy Efficiency Strategies, working closely with Local Authorities and other stakeholders.
- 8.6. In para 8.16 Ofgem note that the projects in RIIO-2 have largely been hydrogen related and that the same scale may no longer be required under the HTBM and government decision on hydrogen heating in 2026. It is our view that it is premature to reach this conclusion with the HTBM in its infancy and the hydrogen for heat decision yet to conclude. It is clear that consumer uptake of heat pumps is limited and as a result it is in line with Ofgem's net zero obligations to keep options open that may enable a more cost effective and socially acceptable route to decarbonise the energy system. Hydrogen, hydrogen blending and an extended role for biomethane are consistent with this approach.
- 8.7. In RIIO-3 we see a maintained requirement to continue to undertake regional studies and early development work to understand the whole energy system impact of decarbonisation, fitting in with the role of the Regional Energy Strategic Planners (RESP) under the National Energy System Operator (NESO). As we progress further towards net zero during RIIO-3 it will be critical to work closely with the relevant actors to deliver plans, programmes of work and the tools to ensure a cost effective and efficient delivery of energy for all consumers. Key to this will be engagement with stakeholders across the various sectors such as industry, power and transport and engagement with devolved government and Local and Regional Authorities.
- 8.8. The role of other green gases, such as biomethane should not be underestimated and how this can be developed further to decarbonise areas of the network at a regional level, requiring the appropriate funding to deliver studies or capital projects to facilitate entry. Biomethane could be a solution to decarbonise our Statutory Independent Undertakings in Scotland.

**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?**



- 8.9. **We agree with Ofgem's initial position to retain this specific re-opener mechanism during the RIIO-3 period.**
- 8.10. We would see this mechanism continuing to facilitate the early development, design and pre-construction activities associated with biomethane, hydrogen blending, and other low carbon alternatives to natural gas, including pre-FEED and FEED studies, where these are likely to exceed the materiality cap under the NZARD UIOLI. It is our view that this provides a point where the networks, regulator and government can confirm alignment of objectives and consistency between project deliverables and any future policy approach.
- 8.11. We see a requirement to continue to fund any activities that the UK government require to be undertaken by the networks as part of Hydrogen Programme, where further assessment or evidence is needed towards the Heat Policy decision in 2026 around the role of hydrogen in domestic heating.
- 8.12. There will also be a requirement to fund additional resources within the GDNs as the role of the NESO and RESPs develop, where networks can support the transition from the ESO to a more granular strategic energy system at a regional level under the NESO.

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

- 8.13. **It is SGN's view that the mechanisms should be kept separate as they each fulfil distinct and valuable purposes, as set out below.**

#### **Allocation of costs**

- 8.14. In considering the re-opener structures, we think it important to consider how the costs for different types of projects should be incurred by GB consumer. It is our view that where projects directly impact the network and the consumers in a licence area, it is appropriate that those consumers should fund or receive the benefits of that reopener.
- 8.15. There are also projects which are more innovative, or evidence based, and where the benefits will be felt widely across the GB consumer base. In these instances, there should be a clear mechanism through which the costs of the project can be recovered from the broader consumer base rather than just the licence area.

#### **Network contribution**

- 8.16. With the publication of the HTBM incumbent networks cannot assume they will have a role in the delivery or the operation of hydrogen transport infrastructure. As a result, we feel it is inappropriate for network company investors to continue with a 10% contribution when there is no longer a reasonable expectation of a financial benefit to those companies. We therefore think that the funding contribution under each of the re-openers should be re-assessed to appropriately align funding expectations with potential benefits.

#### **Net Zero And Reopener Development Fund - Use it or lose it (NZARD UIOLI)**

- 8.17. It is SGN's view that it is appropriate to keep separate the NZARD UIOLI as a defined allowance for smaller, no regret capital projects and early development work such as pre-FEED studies, engineering design activities, and associated stakeholder and customer engagement. This work is hard to predict and valuable to progress with a cap on expenditure of £2m. Returning to Ofgem to seek approval for each of these projects will create a significant administrative burden and delay projects progressing. By keeping this funding separate we have been able to respond to requests from central and local government, and as they are not 'innovation' projects they would not have been funded under the NIA or SIF.
- 8.18. In RIIO-2 the NZARD UIOLI has allowed studies to be undertaken that deliver early development work through pre-FEED, FEED and regional whole system planning studies that align with Local Area Energy Plans (LAEPs) and/or in Scotland Local Heat and Energy Efficiency Strategies (LHEES), working closely with Local Authorities and other stakeholders. Examples include:

- **Hydrogen Vision for Edinburgh and south east Scotland** - We developed a 2045 vision for the Edinburgh and south east Scotland hydrogen economy, demonstrating the role low-carbon hydrogen can play in unlocking the region's green future. Produced in collaboration with a diverse range of stakeholders from industry and government, this Hydrogen Vision set out the foundation for a resilient, clean energy network, linking production, transportation, and end users of hydrogen, while also illustrating the economic benefits such a transition would bring.
- **H2 Connect** – This Pre-FEED project established an optimal design to connect a hydrogen network in central southern England. The project focused on the future expansion of hydrogen production, storage, and imports in the Solent region. Working closely with National Gas Transmissions Project Union, the study demonstrates how the gas industry can safely and practically transport hydrogen through its network of pipes, plus the strategic planning required for system transformations, while converting gas networks in an affordable and practical way that guarantees the continued security of supply to consumers and businesses.
- **Scotland Whole Energy System Infrastructure Evaluation** - This project demonstrated the benefits of collaboration between power and gas systems and provided pathways for achieving these benefits. The clean energy opportunity in Scotland is large but requires strong collaboration and coordination to be transformed into reality. Whole system planning and integration have the potential to position the country as a leader in green industrialisation, as well as a key energy exporter to the rest of GB and Europe.

8.19. In RIIO-3 we still see a requirement to undertake further regional studies and early development work to understand the whole energy system impact of decarbonisation, fitting in with the role of the Regional Energy Strategic Planners (RESP) under the National Energy System Operator (NESO). We anticipate that projects will focus on hydrogen blending, biomethane deployment and detailed planning to support the RESP, LEAPs and LHEES. This work will be required regardless of the role of gas and hydrogen in the net zero energy system.

8.20. The nature of these pieces of work are more suited to a funding mechanism that provides a set allowance for the regulatory period, with networks managing the spend on a project-by-project basis. These activities tend to be of short duration and below the materiality threshold set by other funding mechanisms such as NZASP and require the flexibility and responsiveness offered by the current guidance for NZARD UIOLI.

#### **Net Zero Preconstruction work and small net project re-opener (NZASP)**

8.21. The Net Zero Pre-Construction Work and Small Net Zero Projects Re-opener (NZASP) was created to allow network companies to undertake early design, development, general pre-construction work, and net zero facilitation capital projects that will enable the achievement of Net Zero Carbon Targets. It has also been used to fund large scale demonstration and testing projects, such as LTS Futures, which contribute significantly to the evidence base for hydrogen and would not have been funded through alternative mechanisms. The NZASP has a threshold of £1m which is lower than the threshold applied to the net zero reopener.

8.22. It is our view that this has proven to be a valuable mechanism through which to respond to requests to provide evidence to the Government Hydrogen Strategy, and to provide the appropriate funding mechanism through which trials and extensions are carried out and completed.

#### **Net Zero Reopener (NZRO)**

8.23. At the start of RIIO-2 the Net Zero Reopener (NZRO) was to provide a means to amend the price control in response to changes connected with meeting Net Zero targets which have an influence on the costs and outputs for network licensees. As such it was a broad mechanism that was triggered by the authority where a change in costs exceed the materiality threshold of 0.5% of annual average base revenue (after TIM is applied).

8.24. Given the broad reach of this reopener, the materiality threshold, and the Authority based triggering of it, we think that it is reasonable to keep it in place as a separate mechanism.

8.25. It is our view that there could be a justification for combining this with the heat policy reopener and to have a single broad policy related change and strategic projects reopener. If the NZRO was to be combined

with the NZASP, then it would be important to keep the characteristics of the NZASP but to remove the cap on expenditure.

**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?**

- 8.26. **We agree that the appropriate mechanisms should be in place for electricity and gas distribution companies to continue to participate in collaborative projects where the benefits are realised for both gas and electricity customers.**
- 8.27. This is particularly important for whole system solutions, which can be developed and funded across gas and electricity consumers. This should be tempered by a clear understanding of where the benefits will be realised, and an appropriate cost allocation to gas or power customers.
- 8.28. This mechanism has not yet been utilised in RIIO-2 but as the role of the NESO and RESPs becomes clearer during RIIO-3 this may bring into focus a need to utilise this mechanism as cross vector whole system analysis begins to be undertaken.
- 8.29. It is important to note that there is a difference in the operation of gas and electricity networks. For gas networks we see very limited new investment. The majority of our expenditure is focused on keeping the network safe and reliable. This will remain the case until there is a clear decarbonisation pathway that is accepted by the consumer and where there is a consumer lead migration away from the gas networks. At the moment we do not see this occurring.
- 8.30. Alternatively, it may be that constraints on planning and delivering capacity in the electricity system led to a greater role for gas networks in transporting hydrogen as an energy vector to provide energy system resilience. It may also be more cost effective to convert constrained renewable energy into hydrogen to transport it across the country and store it than to instal substantial electrical infrastructure.
- 8.31. Whilst the decision on future government policies is still to be made, there is uncertainty around the role gas networks will play in meeting net zero, different pathways may again see benefit through the CAM, as may be the case where a decline in gas demand occurs as consumers switch to alternative low carbon solutions through the electrification of heat. Along with an increase in renewable generation to provide the energy to supply heat, the resilience of the electricity network, which is currently supported by gas fired generation or peaking plants, will be critical to ensure security of supply. It would therefore seem inappropriate for a diminishing gas consumer base to pay for any network capital expenditure associated with new peaking plant to benefit electricity consumers and the CAM would seem an obvious mechanism to ensure the transfer of funds from power to gas to provide the resilience to electricity consumers.

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

- 8.32. **Yes, we would fully support the approach of maintaining the physical security reopener particularly with DESNZ currently undertaking a review of its physical security policy. We also agree that it may be desirable to integrate this to a broader resilience reopener.**
- 8.33. In RIIO-2 due to limited growth on the network and broadly constant levels of demand we have not been required to undertake significant upgrades to the physical security of our Critical National Infrastructure sites beyond that put into the original business plan.
- 8.34. We recognise that demand patterns do change and updated guidance in spring 2024 may be challenging to fully integrate into the business plan if there are significant changes in expectations. On this basis we would support the continuation of the reopener, or the integration of this reopener into a broader resilience reopener.

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

- 8.35. **Yes, we agree with Ofgem's proposed approach to the resilience reopener. Recent years have demonstrated the importance of improving resilience, however, we need to be clear on what the expectations are, and what is reasonable to submit through the reopener.**
- 8.36. Improving resilience of the energy networks is important, and it is important to continually recognise that direct resilience (of the network itself) and the indirect resilience (of all the supply chains impacting the network) are inextricably linked.
- 8.37. As a result, we think it is very important to have clear principles on what is included within the resilience reopener, what level of resilience is considered appropriate and what level of cost is deemed appropriate to provide that resilience.
- 8.38. As an example, in a situation where there is a gas security of supply issue, gas networks may have the visibility to know where critical sites (such as hospitals) are on the network but are unlikely to have the control to ensure that those sites stay on whilst other non-critical sites are disconnected. There is therefore a point of principle that should be established as to whether it is the responsibility of the network or the critical site to ensure resilience.
- 8.39. Secondly, it is important to recognise that changing expectations are not always published in a clear and robust manner. In Para 8.49 the SSMC suggests that government or NESO requirements can trigger the reopener, from our experience the requirements may not change and may be stated in a very board manner, the expectations of what the steps necessary to achieve those requirements may however change significantly over time. It is therefore important that any reopener allows for changes in expectation as well as changes in requirements.
- 8.40. Recent history has shown the impact of the pandemic and supply shortages, but most notably the number of storms that have hit the UK. Government departments are encouraging utilities now more than ever to be resilient, not only in gas transportation but also in our ability to communicate rapid and up to date information to engineers and the customer base. Now that public switch telephone network (PSTN) is being removed, the impact is that phone systems are now likely to not be available which causes many issues including the ability to respond in emergencies. The threat of rota disconnection has been with the nation for the last two to three years and grew with the invasion of Ukraine. This has changed the mindset of the government and is an example where international events have impacted change and would require appropriate funding to potentially to manage changing expectations.
- 8.41. Many of these factors are being driven from outside of our industry, and therefore the ability to be able to respond to the risk or change is critical to enable a continually resilient network.
- 8.42. Finally, as set out in OVQ23 we think that there is an opportunity to combine the resilience reopener with the climate change resilience reopener at least whilst an effective approach to including it within the NARMs model becomes established. As with climate change resilience, it is our view that resilience more broadly could be introduced into the NARMs methodology, this however will take time and it is right to have a reopener in the meantime.

## 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?

- 8.43. **We agree with the use of the Opex escalator for where operating costs are clearly variable and can be attributed to a unit cost. It is however important to differentiate between fixed and variable operating costs.**

- 8.44. In RIIO-2, the GDNs had relatively few volume driver variant allowances. However, it is clear that where a volume driver is used, the value adjustment within the licence is often poorly calibrated and often bears limited relationship to the actual cost of the work. This lack of calibration can create poor incentives to either complete too much work or to complete too little work. In part this calibration is due to the absolute value that is produced through a benchmarking approach, and in part as there is no distinction between the fixed and the variable components of operating costs.
- 8.45. It is our view that the use the Opex escalator should remain open for all networks in RIIO-3 until the business plans are submitted and there is greater clarity on the level of uncertainty mechanisms and volume drivers to be implemented.

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

- 8.46. **We recognise the increased number of uncertainty mechanisms within the RIIO-2 price control to better deal with flexibility in the rapidly changing energy space, we also recognise this increases regulatory burden with assessing and monitoring such variant allowances. We believe this should be tackled with ensuring regulatory guidance and licence drafting is robust to prevent any unintended consequences. While Ofgem has put forward two possible options to monitor the delivery of UMs, we note these do not correct the underlying issue of lack of clarity through the cost assessment process of defined outputs against allowances.**
- 8.47. We do recognise that there is a discrepancy, for many network companies (all those with costs above the frontier performance) where funding may have been applied for within the business plan but not carried through to a defined output, or where there may not have been an appropriate driver in the regression model and funding for a higher level of ambition was therefore removed.
- 8.48. Because both the frontier company and the level of ambition they present is unclear at the time of business plan submission, and due to the benchmarking model being relatively crude and of limited accuracy there is risk of different interpretations as to what elements of a company's original business plan is ultimately allowed, outside of defined outputs. As such, this can add difficulty for companies to present uncertainty mechanisms differing from a business plan submission.
- 8.49. As we move towards more agile regulation and greater use of uncertainty mechanisms, we believe that there is a requirement to have greater clarity of how that interaction between business plan submission, final determination, and uncertainty mechanism application should be considered.
- 8.50. It is our view that this requires greater transparency across networks on what is included in their core business plan and what are the measures that they are taking to show ambition and move beyond core services. This also requires greater transparency regarding the final determination and where either there is an appropriate driver to reflect that ambition, or in the absence of an appropriate cost driver, whether there is a positive outcome or not on a technical assessment.
- 8.51. If there is not an appropriate cost driver or a positive outcome on a technical assessment, then it should be eligible for a reopener if it falls into one of the appropriate reopener categories.
- 8.52. Ofgem have suggested two possible options to effectively monitor the delivery of UMs. We would agree with the approach that there should be increased governance within cost and output submissions but note that in order to increase the governance there needs to be a process set up front as part of the disaggregation of allowances to define more robustly how the cost and outputs are aligned within each networks unique allowance setting.
- 8.53. We believe the approach to apply punitive penalties to companies that are found to have repeatedly provided inconsistent data would be unfair, as the RIIO-2 process did not provide the link between

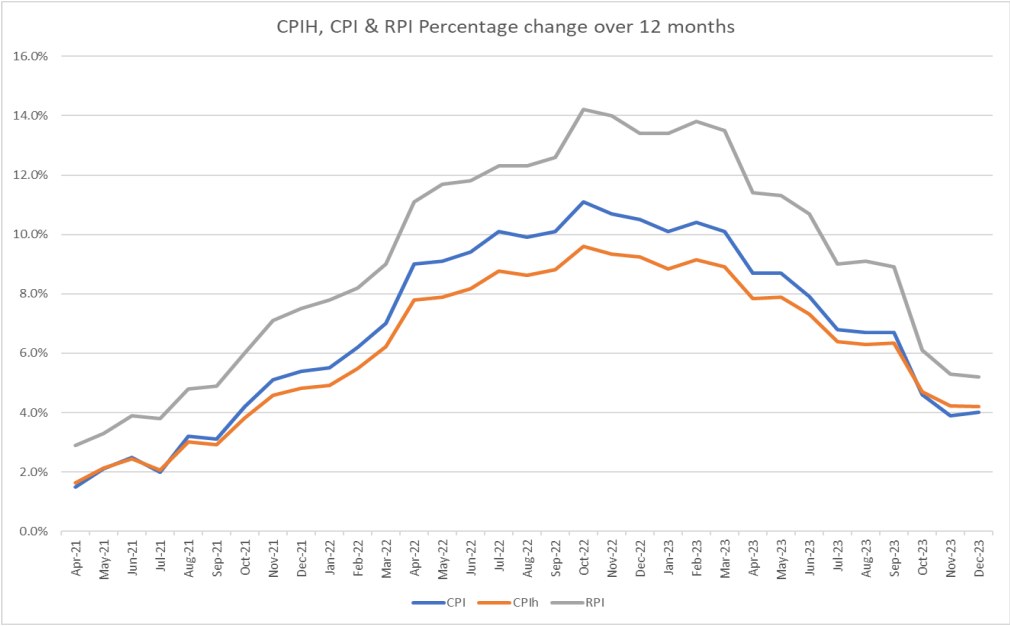
allowances and outputs across the entire totex view in a transparent way to allow companies to provide the data to Ofgem consistently.

9. SGN’s response to questions within SSMC Section 9. Cost of Service

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?

- 9.1. **It is important that the RPE methodology evolves in RIIO-3 to improve the accuracy of the RPE data sets and the timeliness of how the data flows through the cost assessment models. It is also important that the ongoing efficiency methodology is reviewed to account for the most up-to-date and relevant data.**
- 9.2. Ofgem’s methodologies for RPEs and ongoing efficiency for RIIO-2 included flawed logic and application of the evidence that was available. We believe both areas require methodological changes for the RIIO-3 period to reflect both issues with the RIIO-2 approaches and new considerations for RIIO-3 and beyond.
- RPEs
- 9.3. The concept of Real Price Effects (RPEs) is an important protection for both customers and companies to ensure the inflation protection offered to networks is better tuned to the activities that we undertake. As such the pre-set design of RPEs around; index choices, cost structure and appropriate ex post true up mechanisms are vital to ensure a suitable mechanism. Without an appropriately calibrated RPE mechanism either customers or companies could be exposed to cost pressures that are out with control of companies.
- 9.4. The RIIO-2 price control period has experienced levels of macro uncertainty that were unexpected during the setting of the RPE methodologies. As such, the volatility of the RPE factors has been significant (due to the majority of forecast RPEs being based on the OBRs average earnings forecast).
- 9.5. As well as the volatility, the actual adjustment through the RPE does not seem appropriate, particularly in regard to labour adjustments. We note that the labour element of the RPE adjustment to date within RIIO-2 is negative against CPIH inflation. This seems illogical as labour and contractor costs (for which the labour element of the RPE covers) are more commonly indexed to either RPI or CPI, which both have shown a positive wedge against CPIH within the RIIO-2 period, as shown below across the RIIO-2 period.

Figure 5: Wedge shown for CPIH against CPI and RPI within the RIIO-2 period to date<sup>43</sup>



<sup>43</sup> ONS



9.6. While we acknowledge labour price adjustments do not have to be completely aligned to CPI and RPI, as discussed previously it is common for contractors to build inflation protection within their agreements at either CPI or RPI, and as such this wedge should be a consideration when assessing if indices are appropriately matching to the cost pressures companies experience.

9.7. Areas that we would propose Ofgem should review during the RIIO-3 price control setting include:

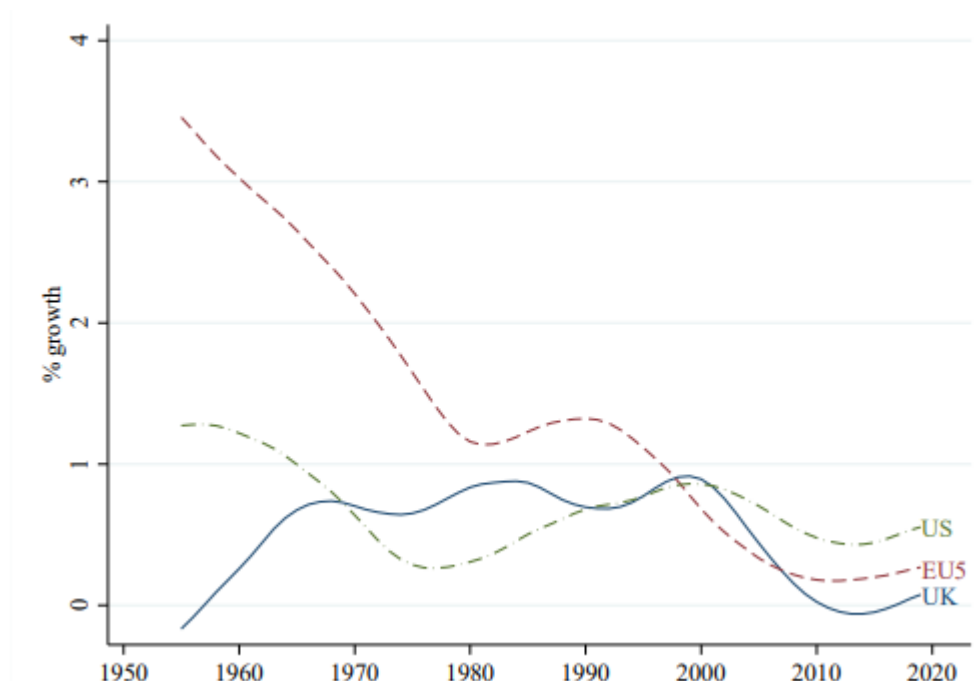
- **The notional cost structure used to set the RPE assumptions.** The cost structure is important to ensure the correct allocation of chosen indices. Increased consideration should be placed on network differences due to regional factors, for example those networks within Southern regions are more likely to have a higher proportion of labour/contractor costs compared to materials due to the increased regional labour wages in Southern. Material cost pressures are not regional and as such a notional cost structure fails to account for regional differences.
- **Indices that are better aligned to cost pressures.** Particularly for labour-based costs, the choice of indices has not tracked the cost pressures that companies have experienced. As discussed earlier, the RPE element of the labour adjustment within the RIIO-2 period has shown a negative adjustment, yet SGN has experienced contractor price increases during the same period. Consideration should also be placed on the CPIH to CPI/RPI wedge, which during the RIIO-2 period so far has shown a greater CPIH wedge. The CPIH index is not traditionally a common index that salary increases, nor contractor increases are calibrated to, instead CPI/RPI is more commonly utilised.
- **Investigate more specific indices to reflect contractor RPE.** The current approach combines contractor and direct labour in order to make a RPE adjustment, utilising the same indices. The cost pressures that contractors face is more nuanced than direct labour adjustments. Contractors are separate independent businesses, and while the makeup is mostly of direct labour, these companies will also be exposed to wider cost pressures related to an increase in volatility within GB (interest rate risk, macro uncertainty driving risk, increased uncertainty regarding the sector future, further increasing risk). These extra risk factors are likely to be muted within the indices utilised and may require a suitable wedge adjustment to suitably cover the RPE within more volatile times.
- **Approach to forecasting for indices when there is no publicly available forecast.** Ofgem currently utilise a Long Term Average Growth (LTAG) approach to forecast indices that do not have a publicly available forecast. Within the RIIO-2 period, the volatility of indices, particularly material based indices have been extreme, and as such the LTAG approach has not been suitable as a forecasting method. While the ex post true up mechanism corrects for forecast differences annually, there has been an increased cash flow risk due to the gaps between the forecast and actual indices, further adding volatility risk to customers and companies. Within the RIIO-3 period we would suggest investigating alternative methods to better tune index forecasts when public data is not available.

9.8. Within the RIIO-3 period we believe the RPE mechanism can be improved upon vs the RIIO-2 process; helping to ensure suitably calibrated inflation protection for customers and companies. If there is unsuitably calibrated inflation protection this will create a further risk within the regulatory regime, which will need to be considered in the wider setting of the price control.

#### Ongoing Efficiency

9.9. We believe the concept of Ongoing Efficiency within the price control should be reviewed ahead of the RIIO-3 price control period. There is significant evidence that productivity growth has slowed across western economies and that in the UK productivity has typically lagged behind other nations, commonly referred to as the 'productivity puzzle'.

Figure 6: Total Factor Productivity Growth in the UK, Northern Europe, and US<sup>44</sup>



- 9.10. Since the Bank of England released its report into the UK productivity puzzle in 2014<sup>45</sup> there has been extensive academic research that is specific to the UK and the ONS produces regular research reports into UK productivity and the contribution of each economic sector to that productivity<sup>46</sup>.
- 9.11. As a result, we do not think that it is appropriate to utilise the same methodology as RIIO-2 without a broader assessment of productivity in the UK and the most recent data available. We note that the EU-KLEMS data base normally runs several years behind in terms of data availability with the Feb 2023 release only having data until 2020 and has not yet been updated to provide a sectoral breakdown<sup>47</sup>. As such we are concerned that the EU-KLEMS database no longer provides the most robust point of reference from which to assess UK productivity.
- 9.12. It is important to take a balanced view of the evidence, it is apparent from the literature that there was a structural break in productivity growth before and after the financial crisis of 2008. The evidence needs to be critically assessed as to whether data points prior to 2008 are relevant, which assessment should consider the full range of methods through which productivity can be assessed and take a balanced view across them including both gross output measures and value-added measures, as well as economy wide and sector measures of productivity. It is unreasonable to assume that utilities are able to outperform the rest of the economy through higher rates of productivity growth.
- 9.13. Consideration should also be taken on what do productivity metrics actually measure, and how they should be interpreted in order to determine any potential Ongoing Efficiency setting. A key concept to improve the process is to appreciate that measures of productivity, including TFP will include gains from both catch-

<sup>44</sup> The UK Productivity 'puzzle' in an international comparative perspective, April 2022, The Productivity Institute, John Fenald INSEAD, Robert Inklaar, University of Groningen. <https://www.productivity.ac.uk/wp-content/uploads/2022/04/WP020-The-UK-productivity-puzzle-in-an-international-comparative-perspective-FINAL-010422.pdf>

<sup>45</sup> The UK productivity puzzle, Quarterly bulletin, 2014 Q2, Bank of England <https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2014/the-uk-productivity-puzzle.pdf>

<sup>46</sup> Productivity Overview, UK: April to June 2023, Office of National Statistics <https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/labourproductivity/articles/ukproductivityintroduction/apriltojune2023>

<sup>47</sup> <https://www.rug.nl/ggdc/productivity/eu-klems/?lang=en>

up efficiencies and economies of scale. The calculation of productivity is simply a 'change in output' for a 'change in input' and does not specifically determine what is the cause of this change.

- 9.14. As such, a process that chooses the highest possible value of determined efficiency improvement from a range would be inappropriate as there will be a double count of the set 'catch up' efficiency targets within the base cost modelling approach and whatever Ongoing Efficiency set.
- 9.15. An equal challenge against selecting the greatest determined efficiency improvement from a range is the concept that OE to some extent is already captured within the use of inflation measures. Company RAV will be indexed to CPIH within the RIIO-3 period, and this index to an extent will be partly depressed due to productivity improvements across GB. Using the logic that Ofgem applies for RPE, Ofgem should ensure that the setting of OE accounts for elements of productivity that are already captured within CPIH.
- 9.16. Due to the various challenges presented above, Ongoing Efficiency as calculated within the RIIO-2 period is not appropriate going forward and requires methodological updates for the RIIO-3 periods. We believe the data should be followed to set a suitable Ongoing Efficiency challenge, and due to the lack of productivity improvements across GB as well as other regulatory mechanisms already including elements of Ongoing Efficiency, there are strong grounds to not have a specifically defined Ongoing Efficiency within the RIIO-3 period. We will support with the determination of an appropriate Ongoing Efficiency challenge ahead of the RIIO-3 period.

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

- 9.17. **We do not consider that it is appropriate to apply ongoing efficiency to reopener applications on the basis that reopener applications normally relate to one off costs which are unlikely to be impacted by wider productivity improvements. For Real Price Effects consideration will be needed only if costs are forecast or currently achieved. If costs had already occurred in would be inappropriate to apply RPEs as the real cost would already be put forward, but in areas where future costs are forecast based upon CPIH inflation, it would be appropriate to ensure a RPE adjustment is applied.**
- 9.18. We believe that it is important to consider reopeners on a case-by-case basis. Where reopeners are applied to new projects that are at the early stages of commercial development and carry significant delivery risk and scheduling risk with them, we think it is important to apply inflation and RPEs appropriately to recognise that the costs will increase over time.
- 9.19. For these same projects, due to the fact that they are normally one-off, early-stage commercial projects or projects with significant amounts of delivery risk, then we do not consider it appropriate to apply ongoing efficiency as there is limited opportunity for realising productivity benefits within a specific project.
- 9.20. Where a reopener is predominantly concerned with costs that have already been incurred then there is no basis on which to apply either ongoing efficiency or RPEs. Real Price Effects should not be applied in this scenario as the costs put forward will already be the real costs deflated to a real price base, and as such there should be no RPE variance.
- 9.21. For future forecasted costs, there will still be an element of uncertainty around the wedge of CPIH and the defined RPE of gas networks, and as such for any forecast element of a reopener there should be an inclusion of a RPE correction.
- 9.22. Where a project is highly repetitive, and the costs are well established, then it is likely that these projects will be reflected in baseline allowances and have RPEs and ongoing efficiency applied to them. If there is a requirement for a project to be funded through a reopener mechanism, then it would suggest that the project is not repetitive in nature such that RPEs should be applied but not ongoing efficiency.

## 10. SGN's response to questions within SSMC Section 10. Providing a stable and predictable financial framework.

- 10.1. Whilst there were no questions provided on this section, Ofgem identify two macro-economic developments which led to the conclusion that there should be a review of the way the regulatory finance toolkit is utilised. These Ofgem identifies these as;
- A. The step change in infrastructure investment need for electricity transmission (ET) to build out a zero-carbon flexible and secure infrastructure at pace<sup>48</sup>. That the requirement to seek fresh equity over and above what they would have funded through retained earnings leads to the notion of investability that is specific to the ET sector and may require consideration of the beta sample to ensure it reflects the forward view on risk, equity issuance, weighting on the timing of debt, and the regulatory depreciation policy reflective of asset lives.
  - B. For the gas sector the FES scenarios as developed by the electricity system operator suggest a rapid fall in gas demand over time from the mid-2030s and as a result the depreciation charge per customer is likely to fall short of the remaining RAV and a gap that would need to be funded<sup>49</sup>. Ofgem then sets out two policy aims<sup>50</sup>;
    - i. To ensure that consumers tomorrow do not pay a significantly higher charge for deriving materially the same value and
    - ii. That consumers today pay no more than necessary and avoid paying for any misconception of asset stranding risk in the WACC.
- 10.2. We welcome that Ofgem have opened up the important debate on these two points, however we do not think that the SSMC provides the correct characterisation.
- 10.3. Firstly, it is our view that investability is as much as challenge for gas networks as it is for the electricity transmission networks, and it is as important to protecting the interests of existing and future consumers, to securing that all reasonable demand for gas is met and that licence holders can fund those activities.
- 10.4. Whilst electricity networks need to attract investment for growth, the gas networks need to attract investment to maintain safety and security of supply in the market. As set out in the finance annex, the gas networks will be increasingly caught between;
- i. Ambitious FES scenarios that are a point of reference for investors and government but, as set out in our response to OVQ7, are unlikely to be realised under the current policy framework.
  - ii. A recognition that there is a legally binding net zero duty that government must deliver net zero by 2050.
  - iii. The risk that new government policies will be introduced to close the gap to the net zero target and that these policies will need to be increasingly interventionist.
  - iv. Whilst government policy drives customers away from the network, there is a significant programme of capital expenditure and ongoing operating costs that must be incurred to maintain the safety and the reliability of the network. This will need to be undertaken, irrespective of policy and FES scenarios, to maintain the safety of the public until the network can be de-energised (i.e., the last customer has disconnected).
  - v. That gas networks will need to attract investment into a market with an increasing risk profile as the RAV falls over time and operating costs become increasingly dominant in the costs charged to customers, and financial resilience declines.
  - vi. To support this declining RAV there would need to be fundamental review of the regulatory model.

<sup>48</sup> RIIO-3 sector specific methodology consultation – Overview Document. Para 10.5 pg. 105

<sup>49</sup> RIIO-3 sector specific methodology consultation – Overview Document. Para 10.7 pg. 106

<sup>50</sup> RIIO-3 sector specific methodology consultation – Overview Document. Para 10.9 pg. 106

- 10.5. As we set out in Section 4, given the public have not shown that they are unwilling to make the migration away from gas networks even with significant subsidies, and given that politicians have appear unwilling to mandate a transition from gas heating systems to electrical heating systems, it appears that the FES scenarios are odds with customer and political reality.
- 10.6. However, the FES scenarios are recognised by Ofgem and Government as the pathway to decarbonisation, and investors are pricing in the risk in the debt markets today by increasing premiums and reducing debt tenors. This is creating a cost to the UK consumer today.
- 10.7. The indirect implications of these decision also need to be considered on a whole-systems basis, as decisions could undermine resilience and security of supply prematurely before customer has had an opportunity to transfer and before the electricity networks had an opportunity to develop the resilience necessary to deliver to the 1-in-20 peak winter that gas networks currently to deliver to covering that an increase of up to 8x the current maximum electricity demand, that is likely to occur on that cold low-pressure, low-wind, clear skies winters' day in early January.
- 10.8. We set our concerns on Ofgem's approach in the introduction to the finance annex, however we would note that the increased cost pressures this places on customers' bills will risk squeezing out measures that otherwise they may have strongly supported such as supporting vulnerable customers, innovation, or green gas development.
- 10.9. It is for these reasons that a much more strategic policy consideration needs to be made, firstly in terms of the confidence of the FES scenarios actually being realised, and secondly the implications of making a significant regulatory intervention, such as accelerated depreciation, in isolation.

## 11. SGN's response to questions within SSMC Section 11. Cyber Security

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

- 11.1. **We agree with many of the proposals set out and acknowledge Ofgem's proposal to streamline this area and reduce the regulatory burden particularly in relation to simplifying the PCD's, reducing the number of PCD's and linking back to the CAF position in line with section 11.3. However, we do not think that the assessment of cyber investment or the outputs that are delivered are yet mature enough to include the costs within baseline allowances.**
- 11.2. In this answer we have responded to the lessons learnt from RIIO-2 and RIIO 3 proposals as set out in the SSMC. More generally however, from an SGN perspective whilst OFGEM have attempted to remain flexible by allowing OES's to flex approved funding phasing through the Price Control Period, this has been welcomed, however, there have been challenges where significant change in required spend is required to meet an agreed output. For example, where actual Supplier Costs, after a tender event, turn out to be significantly higher than the estimates used for baseline approval. There is currently no expedient way of approving any uplift in costs and this result in challenges around signing up to contracts with suppliers when the spend is not underwritten.  
**RIIO-3 Proposals**
- 11.3. SGN will continue to seek funding aligned to Cyber Risk Reduction which may be outside of the NIS scope and therefore CAF requirements for example, GDPR and data loss protection.  
**Reopeners**
- 11.4. We note that one of the observations from RIIO-2 is that there have been notable variances in the quality, type and volume of reopener applications submitted through RIIO-2 reopener windows<sup>51</sup>. Due to the high levels of confidentiality surrounding the cyber reopeners, this is incredibly challenging for us confirm. However, we agree that the reporting burden is high and significant variability would increase it further.

<sup>51</sup> RIIO-3 sector specific methodology consultation – Overview Document. Para 11.18 pg. 112

- 11.5. For these reasons we think that the reopeners are important, however, we would encourage greater transparency across networks (between those with appropriate security access) in terms of the reopener submissions themselves and with Ofgem in terms of quality of the reopeners submitted.
- 11.6. We would recommend a separate independent Reopener for Cyber Resilience (not part of a broader, general Resilience Reopener) in order to retain focus on Cyber Resilience from both SGN and Ofgem, and in order to mitigate challenges around confidentiality within the reopener submission.

#### **PCDs and Reporting**

- 11.7. We agree that the reporting burden for PCDs has been high. However, it has provided Ofgem with confidence regarding the delivery of projects and the scope of projects, so that clear funding requirements for each PCD and each deliverable can be clearly identified.
- 11.8. As such, whilst it has been an administrative challenge, it has also helped to deliver transparency. Within RIIO-2, some Cyber costs are treated as use it or lose it and some are treated as PCDs. It is our view that PCDs can become less granular and progress against them can be subject to less monitoring, we also believe that all cyber costs should be treated in the same manner (i.e., all treated as PCDs).

#### **Cyber Resilience documents**

- 11.9. Ofgem are proposing to align the NIS Regulation obligations and the RIIO Cyber Expectations and to consolidate the cyber resilience reopener guidance with the NIS supplementary guidance. We would agree with this principle that as far as possible there should be just one set of obligations and guidance that should be utilised.
- 11.10. We would, however, disagree with linking reopener applications to changes in the supplementary guidance. Guidance documents are timely to produce and often the direction of travel is established before the guidance document is finalised, networks should be able to respond not only to changing requirements of policy but primarily to a changing threat environment in a timely manner.

#### **IT and OT plans**

- 11.11. **IT and OT plans**
- 11.12. We agree that IT and OT plans should be submitted as a part of the business plan. We should recognise however, that operational costs associated with maintaining cyber security needs to be recognised as an ongoing cost base (including the need to ensure sufficient and skilled workforce).

#### **Allowances**

- 11.13. Whilst we understand the principle that the RIIO-3 price control should set baseline allowances for cyber IT and OT costs we do not think that this is practical currently. It is our view that there is still too much change and uncertainty in the investment that will be required, and we suspect that there is too much variability in the current operating base that operating at that a benchmark from which to improve from can be reliably established.
- 11.14. As such the basis on which costs would be included in the baseline costs needs to be very carefully considered. There is no appropriate driver for levels of cyber security in the benchmarking model, and in the lessons learnt from RIIO-2 it was noted the high degree of variability between network companies on the reopener's quality, type, and volume. This suggests a lack of comparability between networks which would undermine the effectiveness of any cost comparative work across network companies. Again, without a greater level of transparency across networks, then it is very difficult establish a clear basis from which efficiency can be assessed in a transparent manner.

#### **Reopeners**

- 11.15. We agree and support the proposal for a reopener mechanism. It is our view that this should remain broad in its nature and should not have a materiality threshold associated with it.



## 12. SGN's response to questions within SSMC Section 12. Innovation

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?

- 12.1. **We believe the flexible allowance (NIA as is) is a critical element in ensuring innovation can be explored at pace in our sector and support the retention of such a mechanism.**
- 12.2. The NIA gives network companies flexibility to act on opportunities and new learning as they progress with projects, whilst allowing for agile project delivery and efficient planning of resource. An example of the work we are leading for the whole industry funded by NIA is the critical work on safety and technical evidence for the heat policy decision. The focus on supporting the energy transition and also importantly supporting vulnerable customers has also influenced our work and we believe that that this will be increasingly important in the energy transition. We should retain a focus on reducing the impacts on them with NIA projects such as 'TapSOS' which enables non-verbal customers to raise the alarm when they have an issue.
- 12.3. A large portion of the Hydrogen evidence program has been enabled by NIA funding, Hydrogen will be a critical part of the UK's whole energy system, and without the NIA funding the sector would not have been able to conduct the important work it has into safety and technical research. Alongside the other important work network companies have done regarding vulnerable customers and the energy transition.
- 12.4. Looking forward one of the significant unknowns is the impact of de-energisation and decommissioning the network should that be required. Significant investment may be required to accommodate changing networks flows, removing gas from the network and changing investment requirements to enable the safe de-energisation of the network. This is an example of where NIA funding can help to support the efficient development of options.

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?

- 12.5. **We believe the competitive element is a very useful mechanism to enable innovations that are relevant to our strategic challenges in the sector and support the retention of a SIF-type competition.**
- 12.6. SIF is flexible enough to allow new entrants into the industry too, and having stages such as discovery, alpha & beta enables an appropriately cautious but agile approach to high risk, but potentially high reward innovations whilst protecting customer money. We have a number of SIF projects underway including large scale projects, one in particular is the Intelligent Gas Grid (IGG) program, which would not be possible without SIF funding, this sets out the future efficient operation of our network (regardless of what is in the pipes).
- 12.7. Recent SIF rounds have become too precise and more of a problem definition / statement rather than challenge themes, this has made it difficult for innovators and networks to fit projects to problem definitions rather than challenge themes and thus losing the potential to progress some good project scopes.
- 12.8. Broad themes are also very useful, something that the water sector did well with their innovation competitions, using thematic approaches rather than detailed challenges, thus enabling innovative approaches and reframing to occur. Those such as the four strategic themes Ofwat use, [link here](#). SGN are working closely with Ofgem to work on key issues of reform of the SIF.

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?

- 12.9. **We believe that the structure of the price control innovation funding is currently working well and is aligned with a focus on whole systems problems and other public sector initiatives, as such we are not aware of a compelling case for change, the evidence base or the scale of impact identified that are motivating some of the proposed reforms.**
- 12.10. Within para 12.16 and 12.17 Ofgem set out a number of criticisms of the SIF and NIA. Without an evidence base that sets out the scale of the problem and how it is materialised then it is very challenging to agree or disagree with the statements that have been made.
- 12.11. What we can say is from the projects that we are involved with that we do not recognise the suggestions, or we think that there is a risk that the scale of the problem may be overstated. Some of the concerns that have been set out in the SSMC include;
- Projects should be delivered as BAU. Within RIIO-2 there was a significant change to remove projects that deliver efficiency benefits from the scope of the NIA and to focus on projects that deliver environment, social or decarbonisation benefits. Without a direct financial support, we do not believe that these projects would be delivered through BAU as there is no financial benefit to the network from these projects.
  - Projects are duplicative or there may be overlap between the SIF and NIA. Whilst we agree that there is a risk, there are high levels of collaboration between networks and agreed research themes to minimise the likelihood of overlap. Secondly the innovation portal is an important tool in protecting against overlap, we therefore do not consider there to be any significant evidence of overlap or double funding.
  - NIA may be disincentivising applications to the SIF. We consider the two mechanisms to have very different aims and objectives. We do not agree that there is a disincentive to apply for SIF because of NIA, this is evidenced by the number of applications that are presented to SIF in each round, it is always well subscribed. The SIF also has different themes to the NIA, which are used differently by organisations, with more experimental, riskier projects, starting slow and modest with desk research before moving through the process to physical demonstration.
  - Evidence gaps around the outputs of NIA projects. We are unsure of the evidence gap Ofgem are referring to. SGN are thorough in ensuring all projects are reported on the ENA's Smart Networks Portal and there is ongoing work on innovation measures across the networks, involving a number of different parties. It is worth noting, however, that many 'in-flight' projects may not be at the point of sharing benefits as the project is still being developed and therefore the benefits are yet to be realised. Alternatively, some projects may conclude in closure due to unsuccessful results and therefore there would be no benefit to evidence.
- 12.12. In the SSMC Ofgem propose that there is an opportunity to improve the outcome (para 12.22) through a focus on minimum standards of quality (timelines, deliverables, budgets, and demonstrating that they would not be delivered in the core price control). Secondly, Ofgem suggest that there is an opportunity to ensure that money spent on innovation projects is maximised by checking that projects have plans in place to roll out solutions and ensure they are not duplicative.
- 12.13. We agree that there are opportunities to improve the outcome by focusing on minimum standards and confirming that the projects are not duplicative.
- 12.14. We are concerned that checking that projects have plans in place to roll out solutions, from our perspective is not appropriate. The innovation mechanisms take projects to TRL 7, and as a result there is still some significant distance to progress having a full-scale commercial roll-out. A good example is SGN's remote pressure management PCD which looked to deploy innovative technology at scale and there were significant changes required to the technology that was successful at an innovation stage to adapt it to broader commercial applications. This had a significant impact on the cost and the timeliness of the project delivery.
- 12.15. Looking forward it is our view that a whole systems approach is critical, and important to ensure customer money is utilised in such a way that maximum benefit can be achieved for all. Broader themes will allow

freedom to explore truly breakthrough innovations with new entrants into the sector, cross-sector collaboration will also be essential, and would also align with Ofgem's case for change (section 12.9).

- 12.16. SGN has already worked cross-sector with funding mechanisms such as the lane rental scheme from TfL, enabling us to improve street-work safety and minimise disruption with new innovations in collaboration with other organisations. By utilising this approach, it not only helps SGN stakeholders and consumers but also the other utilities that collaborate within the projects.
- 12.17. NZARD (UIOLI) has also proved to be an excellent and flexible mechanism for the development of regional, whole system solutions. Our Whole System Infrastructure Outlook for Scotland was a collaborative project lead by SGN in partnership with NGT and supported by the relevant DNO's, the Scottish Government and the ESO. A further study supported by the renewables industry and with academic input considered the potential for curtailed and constrained onshore wind in SW Scotland to produce green hydrogen. Both these projects demonstrate the strength of a collaborative whole system approach to optimisation of the energy system. They underpin regional infrastructure solutions, support the evidentiary base for hydrogen as a multi-sector decarbonisation vector and identify where further innovation is required and detailed evidence gaps exist which can then be delivered through NIA. The continuation of this flexible and iterative process of funding will be crucial to maintain momentum to Net Zero in RIIO-3.
- 12.18. As we move towards a more integrated energy system, supplied from a diverse range of renewable and low carbon sources, the need to ensure a coordinated approach towards investment, operation, and the impact this has on consumers is increasingly important. The whole system approach to this is essential in delivering solutions that support decarbonisation, ensure security of supply, and deliver at the most efficient cost to consumers.
- 12.19. It is important to recognise that there are different requirements for electricity and gas networks. For gas networks, the decarbonisation pathway remains. It will be important to improve that clarity whilst defining how whole system trade-offs may materialise in RIIO-3.

**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?**

- 12.20. **We agree with the proposal to continue with a similar level of innovation.**
- 12.21. We support Ofgem's view that a similar level of innovation funding should be maintained in RIIO-3 to that offered in RIIO-2 across all the various funding mechanisms.
- 12.22. The challenge of decarbonising our whole energy system is significant, and there is still much work to do to ensure we do this in an inclusive, safe, secure, and sustainable manner.

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

- 12.23. **It is SGN's view that the challenge of including third parties is not significant and would encourage evidence to support whether there is a genuine challenge or not. We believe the networks play an important role reviewing and supporting ideas from 3<sup>rd</sup> party providers and supporting their development.**
- 12.24. Variety is the lifeblood of innovation, and it is critical that there are opportunities for new companies to engage in the energy sector bringing their innovations with them, whatever size they are. The scope must be relevant to the challenges the whole system faces, and that our customers, who fund these endeavours, are protected.

- 12.25. A full assessment of innovation projects conducted by the sector would show the high level of 3rd party involvement. Invariably, ideas that progress through funding schemes such as SIF and into trials and roll out are from 3rd parties.
- 12.26. We acknowledge that not all third party projects are progressed; there is normally a particularly good reason as to why. It is often the case that the solution fails under real-world testing or is not viable in terms of commercial delivery (not affordable to scale), or on occasion we find a better alternative. It is important to note that most of the available innovation funding is focused on low TRL technologies and, as such, they are unproven. The role of innovation teams within the gas network is to de-risk and progress them up the TRL ladder, this can sometimes result in suppliers going back to design, reinventing / redesigning or occasionally dissolving the idea.
- 12.27. The networks in this way provide an important role in reviewing 3<sup>rd</sup> party projects and provide clear feedback on why the projects are not considered suitable.

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

- 12.28. **We are surprised that Ofgem is proposing to establish an accelerator to support early-stage innovators and would encourage Ofgem to clarify the problem that it considers such an accelerator would address. We are mindful that investment vehicles for start-ups is a highly specialised area of work, and it is not clear how this would fit within Ofgem's remit or expertise. As such, we would therefore like to understand the proposals in greater detail.**
- 12.29. Specifically supporting early-stage companies is an admirable initiative and has potential to support the wider UK economy, however, the sector and Ofgem are not an investment vehicle for start-ups. It is important to recognise that this is an area where there is limited to no expertise across the sector.
- 12.30. Reference is made in the SSMC (para 12.35) to the water breakthrough challenge. It should be noted that this challenge is still in its infancy and is yet to prove value. It is our view that it is important to initially ensure that we have the correct diagnosis of the problem and provide evidence to that effect, and secondly to assess whether other organisations are better placed to address the problem that has been diagnosed. We would instinctively look to organisations such as Isle Utilities who operate this kind of process for the water sector and have vast breadth of experience in all utilities.
- 12.31. There is comment in the consultation that states the networks are effectively gatekeepers (para 12.33) of the available innovation funding, which is true, and in reality, appropriate as it is the networks who have responsibility for deploying innovations to their assets and operations in a safe and efficient manner.
- 12.32. If the accelerator goes ahead then networks must be involved in the selection process, otherwise customer funded innovations could be developed with nowhere to be deployed, deployed but in a manner that jeopardises safety and reliability, or progressed as they appear to have a 'stamp of approval' which could lead to worse customer outcomes.
- 12.33. It is not clear why SMEs and small companies are struggling to engage. We are conscious that there may be some innovators who are disappointed that the opportunities they have presented have not been engaged with by industry as a whole, but there may a good reason or it may be a matter of timing for that need to be fully realised. We do not believe that any network company will refuse an innovation that has potential to add true value – whether that's safety, decarbonisation, or efficiency. Unfortunately, networks may not find the benefits case presented by an innovative opportunity to be as compelling as the innovator would like it to be at the time, and this can be for a variety of reasons that are associated with the innovation or the way it is applied.

**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?**

- 12.34. **We broadly agree with Ofgem's proposal, however, would want to understand the basis of the accelerator in greater detail to then determine the most appropriate method through which it should be funded, and how the overall fund size should be adjusted, if it is progressed.**
- 12.35. If the accelerator is to go ahead, and funding allocated from the total pot of innovation, increasing the total pot would be prudent, the earlier stage the idea, the riskier it is. There is therefore a risk that it would squeeze out more developed and established innovation.

**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?**

- 12.36. **Within the RIIO-2 price control SGN successfully applied for three PCDs for innovation projects that would not have been implemented had they not been funded directly via the PCD. It is our view that a similar structure needs to remain in place to enable projects in RIIO-3.**
- 12.37. In our view it is important to distinguish between the innovation project itself and the deployment of the innovation. It is standard to expect innovation to take place over many years and to phase the funding commitment according to the phases within that timeline and adjust the project according to funding available and the prospects of that technology.
- 12.38. The challenge is then moving that innovation through to delivery and the deployment. The returns necessary to fund this may not be sufficient within a price control period to justify the deployment of a technology, or the benefits of the technology may not be directly financial.
- 12.39. In RIIO-2 three projects we submitted by SGN to facilitate innovation projects, these include Remote Pressure Management, Biomethane improved access rollout, and gas escape reduction. These projects were driven primarily by environmental benefits rather than financial benefits to the network company. These are example of projects that would not have progressed if they had not been directly funded.
- 12.40. The reasons why these projects would not have progressed is that there is no appropriate driver in the benchmarking process to recognise the output delivered, secondly there was no or limited direct financial benefit associated and to achieve the environmental benefits separate funding was necessary.
- 12.41. As we set out in our response to OVQ12, we believe that the PCD structure is beneficial as we think that it provides transparency. Funding could be provided through a technical assessment, kept outside of benchmarking and then delivery assessed through the independent stakeholder group (ISG), however it is our view that this will be less robust.

**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?**

- 12.42. **We support the objectives of the future regulatory sandbox (FRS) and support its intention of informing changes to the rules governing energy network activities.**
- 12.43. We note however, that there has been limited application to gas networks to date and we need to ensure that the FRS operates within the safety constraints of the gas network. So, whilst we agree in principle, we need to understand how it would operate in practice.
- 12.44. It is important to understand how the proposed funding structures would also be delivered in practice, but our expectation was that projects with funding already agreed would apply to the FRS for support in creating the right regulatory environment to test that project. We had not anticipated that the FRS itself

would determine the appropriateness of funding at trial and we would be concerned that such an approach could lead to fragmentation of funding and inconsistencies in approaches.

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

- 12.45. **The FRS is at an early stage of development for the gas networks, it may be that the current UNC mechanisms provide a sufficient structure, but we agree that it is important to have an alternative pathway if they do not.**
- 12.46. As an immediate expectation we would anticipate that the FRS trials would be used for supporting hydrogen transport or storage business models where the full requirements of the UNC are not required or are not appropriate. It may also be used for biomethane and opportunities to improve the commercialisation of biomethane or blended hydrogen.

## 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?

- 12.47. **We are surprised by the suggestion that not enough network innovation funded projects are rolled out as this is not our experience. Since the submission of the RIIO-2 business plan where we identified each project and their stage of roll-out<sup>52</sup>, there has been significant change to the originally agreed themes and eligibility criteria. As a result, projects were restricted to those focused on the energy transition and supporting vulnerable customers. We have not seen any evidence on roll-out being either high or low, but this change will have had an impact. The term 'roll out' implies a high level TRL moving quickly into production for efficiency benefits within RIIO-1, this does not align well with the innovation themes set for RIIO-2 and there is a risk that a step-change in innovation strategy does not manage expectations for the expected short-term benefits.**
- 12.48. It would be helpful to understand the evidence basis on current roll-out and the basis on which we can define a reasonable expectation for roll-out of projects as it is very subjective according to the type of projects that are entered into.
- 12.49. It is very important to consider how 'enough' should be defined, as there is no formula or set strike rate for innovations, even venture capital firms are operating at around 0.05% success rate for their investments (depending on your source).
- 12.50. We would be very concerned about any attempt to put an arbitrary target success rate on the roll out of innovation. We believe that this would risk incentivising the wrong behaviour and encourage organisations to opt for 'safe' innovations that have a high chance of being implemented in order to hit arbitrary targets.
- 12.51. We believe that it is more important that the selection of projects to be funded so that they are answering a genuine need, that these projects are managed in a disciplined and professional way, budgets are realistic and adhered to, and that on successful completion of a project findings are disseminated.
- 12.52. We also think that it is important to recognise the diversity of the projects that are funded through the NIA. Not all projects will produce a 'thing' that can be implemented, some of these projects are about producing knowledge such as supporting knowledge for the heat policy decision and providing evidence to move or progress to the next stage of a project, or in some cases recommendations for further analysis or evidence required. These types of projects would be deemed a success in terms of progressing the evidence case for Hydrogen but could also be deemed unsuccessful as there is no immediate benefit realised. An example is our Asset Intervention Database project, this consolidated all networks hydrogen evidence projects to create a base record of all the hydrogen evidence work that has been done and disseminated out to HSE

<sup>52</sup> <https://www.sgn.co.uk/sites/default/files/media-entities/documents/2022-07/Appendix-008-SGN-Innovation.pdf>



for review. This was then linked to the DESNZ evidence management system (EMS), peer reviewed by DNV with all the other networks reviewing each other's work.

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

- 12.53. **Any mechanisms that are introduced need to be carefully considered and could result in unintended consequences. Innovative process should acknowledge the risk of failure and challenges in deployment as such we would be strongly against any penalty mechanisms or performance-based incentives. The conversion of an innovation into commercial reality remains challenging, and in RIIO-2 we specifically requested funding to enable this on a number of technologies and this approach should be retained in RIIO-3.**
- 12.54. It is important to recognise that some innovation projects take years to complete, times, technology, and priorities change during that time period, particularly around the change in strategy and themes for Innovation projects in RIIO-2, with the focus on progressing the evidence case for Hydrogen. This may impede the deployment of an innovation, or it may be that the innovation is successful, but not sufficiently successful to take on the costs of deployment into the field with the associated cost of training and updating procedures. Furthermore, it may be that an innovation is not viable at the moment, but the knowledge gained means it could be viable in the future and needs and priorities change.
- 12.55. As a such there are many reasons why an innovation may not be deployed, and we should not seek to artificially increase deployment through penalty mechanisms or performance base incentives.
- 12.56. As we set out in our response to OVQ54, the conversion of an innovation into a commercial reality remains challenging, and in RIIO-2 we specifically requested funding to enable this on a number of technologies.
- 12.57. It is our view that this has supported deployment, and we think that a similar deployment PCD or roll-out fund would be valuable in RIIO-3 to support the delivery of projects once they have demonstrated the higher technology readiness levels that they are ready to move to commercial deployment.

## 13. SGN's response to questions within SSMC Section 13. Data and digitalisation

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

- 13.1. **We support the move to modernising regulatory reporting, however, there are many dependencies that need to be resolved which makes the timeline look challenging. We should also recognise that this will require investment of time and resources from Ofgem and the networks.**
- 13.2. There are many dependencies to meet before regulatory data may be shared on an automated electronic basis, such as specifying precisely which data is to be shared and agreeing common standards and formats. It also does not negate the need for us to check and internally approve reported data before submission to provide assurance that it is correct.
- 13.3. From a technology perspective, reopener funding in 2024/5 will enable us to mature our data sharing hub to the point where we can automate the production and publication of open data sets but does not go as far as sharing data sets under licence as proposed in the FSNR data sharing infrastructure. For that we would need additional functionality around identity and access management as well as cyber security measures to minimise the cyber-attack surface and protect data related to personally identifiable information and critical national infrastructure. For these reasons we would anticipate being ready to share automated regulatory reports one or two years into the RIIO-3 price control period. This assumes that cross industry agreement is reached over standards and formats.

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?

- 13.4. **We highly support the initiative to enhance the efficiency of providing regulatory information, recognising the broader scope of regulatory reporting that encompasses various submissions from Gas Distribution Network companies to Ofgem. There are challenges in this area to overcome, and SGN is actively pursuing solutions in that arena to the extent these are within its control.**
- 13.5. Current challenges include the provision of extensive and granular details in the Regulatory Reports (e.g., - RRP) by GDNs and ensuring accessibility for all stakeholders is crucial. Aligning all network companies to report costs and relevant information in a standardised manner will enhance clarity and transparency.
- 13.6. It is important to recognise that currently data is often of a dispersed nature of across different systems, and this can pose challenges for integrated regulatory reporting. SGN is developing proposals to improve operational processes and improved integration across these business data systems.
- 13.7. In the more immediate timescale, SGN is developing a Data Ops capability which is being delivered under the Digitalisation reopener mechanism, approved by Ofgem last year. This will provide the foundational capability to curate, govern, transform, and share data in an efficient and secure way. The primary use-case is Open Data, but this capability will also enable SGN to engage with Ofgem's ambitions for regulatory reporting in a more efficient way.

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

- 13.8. **To determine the areas of regulatory reporting that would yield the most significant benefits in the modernisation project, we propose to prioritise those with substantial administrative complexities and a high potential for efficiency improvements.**
- 13.9. Potential areas to consider include:
- Streamlining the regulatory reporting process can improve data collection processes and accuracy, ensuring that the information requested aligns with the necessary level of detail for regulatory purposes.
  - Prioritising the consolidation of relevant reporting information (such as costs and workload) into a centralised system could address the challenge of dispersed data, improving accessibility, data quality and ensure timely use of performance data.
  - Focusing on providing clearer regulatory instructions and guidance can reduce interpretational differences, ensuring consistency in reporting practices across Gas Distribution companies.
- 13.10. While we recognise that this question focusses on priority areas of regulatory reporting to modernise, the wider data governance and technological platforms should also be examined. We believe there is value in considering changes to the modelling suite at the core of Ofgem's econometric model, including what platform could be used going forward and how this might be future-proofed.
- 13.11. Microsoft Excel has shown its value in being accessible and interoperable and will remain the go to application for some stakeholders / products (like the PCFM). However, Excel has limitations in the total volume of data it can process. Additionally, many of the data transformations in the RRP or the cost modelling suite are processed using VBA macros. VBA has not been upgraded by Microsoft for some time and may be deprecated by Microsoft in future as it actively encourages adoption of the Power Platform.
- 13.12. There are other platforms or applications that might be more suitable for processing data, particularly in the context of cloud adoption. For example, we find that running the cost modelling suite on SGN's virtual machines is extremely problematic and can only run with any sort of stability on a single device's hard-drive.

- 13.13. We believe it would benefit Ofgem and the sector as a whole to consider software products that can integrate with other applications, and provide econometric packages on their platforms, or a direct link between their databases and external packages like Stata or statistical programming languages like R, and Python.
- 13.14. Given the challenges of adopting a new platform and building user confidence we do believe such changes will take time and may require a level of parallel running. However, we also consider there to be significant potential benefits associated with improved accessibility, data governance and data quality. Other areas which are less data intensive and need to be accessible to a broader range of people (such as the PCFM) would probably benefit from remaining within Excel.