

# **UK Power Networks' RIIO-3 SSMC response to Overview Document and Finance Annex questions**

## **Overview Document Questions**

### **Future of Gas**

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

This response covers questions OVQ1 to OVQ6. As an electricity distribution network, we do not have immediate views on the impact to the gas sectors of the changing role of gas in the future energy system. However, we do recognise the impact of wider policy decisions on gas will be significant across all sectors. Therefore, appropriate use of future scenarios to inform baseline funding and the use of uncertainty mechanisms will require focus and understanding across sectors to ensure the framework supports most efficient whole-system outcomes for current and, importantly, future customers.

Given the distinct nature and increased uncertainty around decommissioning and/or repurposing costs, Ofgem could explore the use of a separate focused re-opener for this to set allowances once policy and impact are clearer.

Please see our response to questions on scenarios below for more detail on our views in this area.

#### **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?**

Please see our response to OVQ1 above.

#### **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?**

Based on the Government's decision published in December 2023 to support blending of up to 20% hydrogen into gas GB gas distribution networks it appears sensible that the RIIO-3 net zero related uncertainty mechanisms are used to cover emerging costs for this activity. Given that trials are ongoing, government needs to assess the evidence before any steps to implement blending are taken, consideration of any implications from the safety assessment is required, then an uncertainty mechanism of some description looks like the best way of affording protection to customers and enabling GDNs to access funding if required.

We have no specific views on which mechanism in gas distribution is most appropriate.

#### **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)?**

Please see our response to OVQ1 above.

#### **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?**

Please see our response to OVQ1 above.

**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.**

Please see our response to OVQ1 above.

### **Role of Scenarios and Planning Pathways**

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

We support the continued use of the FES framework. Noting that the ESO is currently evolving the use of its scenarios and is potentially moving to decarbonisation pathways with sensitivities we would welcome further clarity on how the new FES framework will operate. Without clarity on new FES arrangements, it is difficult to properly assess its use in RIIO-3. For example, whether there will even be a Falling Short scenario defined. Therefore we believe that Ofgem and the ESO should determine how the FES will feed into RIIO-3 plans (i.e. to inform totex) with coherence and alignment before the FES 2024 is issued.

It is particularly positive to read Ofgem's intention to design a RIIO-3 framework that "is sufficiently flexible to deal with whichever future scenario that materialises in period". We believe this is fundamental to protecting customers by ensuring baseline allowances are tied to high confidence needs and agile uncertainty mechanisms flex allowances based on more up to date information.

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

We believe it is important that Ofgem sets a consistent and common scenario for all sectors to define baseline allowances against. We agree that network companies should forecast expenditure to facilitate all FES scenarios to enable policymakers and Ofgem to see the envelope of expenditure that could be required. Nevertheless, our view is that there should be a single 'whole system' view of what networks should be planning to as part of the RIIO-3 methodology and this would represent a major step forward from RIO-2 arrangements.

Learning from RIIO-2 and recognising the uncertainty of the pace of transition to low carbon technologies, we believe it is important that Ofgem sets baseline allowances on the lowest Net Zero compliant scenario for each sector. A set of simplified uncertainty mechanisms can then be used to unlock the further funding required to match the pace of our customers' demands – this approach was successfully adopted for RIIO-ED2. Given the scale of investment that would be justified using these scenarios, we believe they should be subject to external scrutiny to ensure credibility.

**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?**

We agree with using the envelope of FES scenarios as a basis for all RIIO-3 business plans i.e. all network companies should be obliged to forecast expenditure in the four FES scenarios – this would be equivalent to the approach set out by Ofgem for RIIO-ED1 and would provide Ofgem with a full suite of information, minimising information asymmetry and enabling appropriate calibration of uncertainty mechanisms across sectors. As outlined in OVQ8 when it comes to setting baseline allowances we believe it should be the lowest Net Zero compliant scenario for each sector with UMs to provide the flexibility for the demand that materialises.

Whilst we recognise that Falling Short is not net zero compliant, we believe all networks should forecast expenditure aligned to it, as it is a plausible view on what could outturn over the RIIO-3 period.

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

See answer to OVQ9 above. In short, baseline allowances for gas companies should be set on the lowest Net Zero compliant scenario for the sector which is likely to be Leading the Way. Other scenarios should be used to help define the envelope of investment and to calibrate UMs.

**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?**

This question is principally aimed at ET and Gas companies rather than us as a DNO. Whilst we cannot comment on their ability to update their plans based on FES-2024 we would agree with Ofgem that a risk with using FES-2023 is that it will be the best part of three year's old by the time RIIO-3 starts in April 2026. It is notable that Ofgem did something similar in ED2 by requiring DNOs to update their plans to the CCC's scenarios that were published about 18 months prior to the start of ED2. However, given the timings of converting FES scenarios into DFES projections, we would welcome further discussion with Ofgem ahead of locking in equivalent timeframes and requirements for RIIO-ED3. As part of this dialogue, we would be keen to understand Ofgem's expectations with respect to any customer and stakeholder engagement associated with the updated business plan forecasts, noting that the proposed timeframe for ET and Gas companies is not conducive to meaningful engagement with a large and diverse customer base, but may be practical if undertaken with ISGs.

**Outputs and Incentives**

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

Yes we agree. The focus should be on only placing PCDs on material spend areas. The preference should be for more mechanistic PCDs, (which are automatic reducing regulatory burden) over numerous evaluative PCDs (increasing regulatory burden).

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

We generally agree with the approach. We do believe Ofgem should be mindful of consumers' priorities including in respect to the service provided to them by the regulated companies in the energy sector. The suite of financial incentives should reflect these priorities to ensure a balanced coverage of the aspects that are important to customers.

We encourage the use of static targets where possible. Static targets provide companies the certainty required to build business cases for service improvements and investments that deliver for customers. These targets need to be to be challenging but achievable and simple and objective to measure. RIIO-ED2 saw a backwards step in this essential part of the RIIO framework with examples such as:

- LPN being set targets in the Interruptions Incentive Scheme (IIS) that means it will have to achieve the impossible, a negative CI or CML metric, to achieve the full reward available on this incentive - while still being exposed to the full potential penalty.
- The DSO metrics developed to objectively and clearly measure the performance of emerging DSO capabilities have been removed from the framework after significant effort to develop a robust set of measures.

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

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

We support the simplification of price controls and for this reason do not agree with the use of reputational incentives. A simple set of powerful financial incentives focuses management attention to drive meaningful improvements in performance – reputational incentives dilute this focus.

While we fully support transparency, the reporting requirements associated with any reputational incentives must be informed by stakeholder views of what they find useful to compare company performance. Disproportionate reporting requirements can significantly add to regulatory burden while potentially not providing useful information for stakeholders to hold companies to account.

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

We agree with this approach. However, we encourage Ofgem to avoid situations where the framework development “runs to the slowest horse”. For example, where some companies may argue the reporting required to operate an incentive is difficult, this should not hinder the development of the incentives that have the potential to encourage performance improvements across sectors as has been seen in the case of DSO metrics not being activated in RIIO-ED2.

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

Our environmental performance is important to our customers and we believe this should be reflected in the price control. However, as described in our response to OVQ14 above, we do not believe reputational incentives are the best approach and therefore, we believe the AER should be used as development towards a financial incentive. In the meantime, it is important the reporting requirements are informed by stakeholder views to maximise the effectiveness of these incentives.

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

We believe this format could negatively impact the readability of the document with stakeholders having to cross reference between commentary and data tables in separate parts of the document. This is the format prescribed for RIIO-ED2 but the first set of reports under this framework will not be published until October 2024 so we do not have direct experience or stakeholder feedback at this stage.

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

Please see our response to OVQ14 and OVQ16 above.

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

Please see our response to OVQ16 above.

**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.**

Please see our response to OVQ16 above.

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

Please see our response to OVQ13 above.

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

Yes, we support the continuation of NARMs. We would welcome an early steer from Ofgem on developments for RIIO-ED3 as making amendments, increasing coverage takes time to implement. The work done collectively between Ofgem and DNOs ahead of RIIO-ED2 was a significant

improvement on past price controls and enabled DNOs to submit their RIIO-ED2 NARMS information on the same basis as reporting for the price control period itself. This was a key lesson learnt from the RIIO-ED1 process and has avoided the need for a time consuming and costly rebasing exercise. We would want to replicate the RIIO-ED2 process ahead of RIIO-ED3.

For high-volume, low-cost work we believe there is a significant opportunity to simplify the price control assessment process by utilising the NARMS information to justify investment without the need for “doubling-up” and also providing EJPs.

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

Agree, climate resilience must form part of future investment plans. This could entail looking at design standards to ensure they are fit for purpose for future climate scenarios. Care needs to be taken by Ofgem to ensure additional cost from future proofing infrastructure is not discounted/removed when benchmarking costs against others not considering future proofing in a consistent manner. Making clear what are expected baselines that all licensees must plan for would also facilitate greater comparative benchmarking and help reduce instances of inconsistent regulatory treatment. We note that in RIIO-ED2 we had discussions with Ofgem over the appropriate categorisation of replacement of fluid-filled cables and post submission of final business plans identified that what appears to be equivalent work is reported and assessed elsewhere in the price control by at least one other DNO. Improving consistency and comparability should result in enhanced climate resilience across the respective sectors and aid both Ofgem and stakeholders identify what is being done and where gaps are that need addressing.

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

Please see our response to OVQ23 above. In addition, early signposting from Ofgem on how it would like climate related investment demarcated is beneficial. In the case of the electricity distribution sector this work could be undertaken once the first regulatory submissions under the new RIIO-ED2 Regulatory Instructions and Guidance have been submitted in July 2024.

**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?**

Please see our response to OVQ23 above. This is an important area and there needs to be consistency in the scenarios that companies are planning to. Additional costs need to be identifiable to not harm those companies that are advanced in the benchmarking process. If network companies are given a clear direction, they will ensure they develop proposals in time.

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

We agree this is the right direction of travel, however, it should be combined with the climate resilience metrics to avoid duplication. Further clarity would be welcome on the intention of the metric, for example is it to be used as a true output measure i.e. to set and adjust expenditure allowances in the price control or more to act as a communication tool to stakeholders to demonstrate resilience levels? With the purpose set, network companies can work together with Ofgem to develop proposals that fulfil this purpose and wider stakeholder requirements.

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

Workforce resilience is one of many factors that network companies need to get right along with supply chain strategy, diversity, network resilience etc. to deliver the investment and wider outputs they commit to. Companies set outputs and targets in RIIO Business Plans and are held to account on delivering these – workforce resilience is an enabler to achieve this rather than an output in itself. As we move towards simplifying price controls, we are not clear what benefits reporting on this input delivers. What should be reported is the performance vs outputs and commitments – this is what our customers expect of us.

## **Truth Telling and Efficiency Incentives**

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

### **Truth telling incentives:**

We agree that the objectives of the truth telling incentive should be to support:

- Business plan information that enables Ofgem to set the price control effectively;
- Provision of ambitious cost forecasts; and
- Provision of ambitious output proposals that go beyond baseline expectations.

To achieve these objectives, we believe Ofgem need to be clear about what an effectively set price control looks like. The two levers used in RIIO-2, BPI reward and sharing factor did not suitably distinguish between companies that strived for the above and those that did not. RIIO-3 should address this to deliver meaningful rewards and/or penalties. To provide the clarity required for a meaningful incentive, the assessment of Business Plans should be based on a set of objective criteria established and published before Business Plans are produced and submitted.

Clarity is needed over the potential tension between the second and third of Ofgem's objectives. An ambitious cost forecast may contain both individually stretching unit costs for specific activities as well as an overall stretching totex forecast when considered against Ofgem's key benchmarking metrics. The inclusion of output proposals that go beyond baseline expectations may result in both individual unit costs as well as overall totex being higher than they otherwise would be. For example, intensive preparation ahead of forecasted severe weather can deliver better customer service and improved response times in storms i.e. better than baseline performance but come at a cost – both on reported faults expenditure and against totex in general. It would be helpful if, working with industry and stakeholders, Ofgem could develop baseline performance metrics which can be included in its cost assessment methodologies, such that a company delivering above baseline performance is not subject to a “double-ratchet”, whereby its performance target may be set, in the case of IIS, at the lower (i.e. tougher) of the benchmark and its own recent performance, whilst its cost allowances are determined through benchmarking that fails to take account of differing performance levels.

We remain concerned that, if repeated for RIIO-3 the combined effects of Stages 3 and 4 of the RIIO-2 BPI approach do not provide the right signals to licensees to submit stretching, but achievable cost forecasts. Our thinking is informed by RIIO-ED2, where significant sums were disallowed through Ofgem's benchmarking – benefiting from the cost projections of the frontier company, but no penalties were applied for any of the disallowed costs, and the spread of sharing factors was negligible. Without changes we question what mechanism Ofgem has to disincentivise inflated cost forecasts?

We note the reference to a potential post-code lottery in the provision of certain services and believe this warrants further discussion. If the objective is for companies to provide ambitious output proposals that go beyond the minimum, then there will naturally be divergence amongst companies. This could be addressed through a subsequent requirement for all other companies to adopt such proposals, resulting in the “baseline” moving and all companies receiving funding to deliver against the revised baseline. Whilst feasible, this approach needs to be considered against any customer research undertaken by licensees and whether the imposition of revised baselines on proposed plans has any knock-on implications for other elements of a licensees' plans. Finally, there is a question over the incentive arrangements involved – if all companies ultimately receive allowances for adopting one company's proposal, does the originator of the proposal automatically receive a BPI reward of some magnitude?

### **Efficiency incentives:**

We want to see Ofgem setting stronger in period efficiency incentives for companies deemed to have set the frontier in the price control assessment and lower sharing factors for those companies assessed to have put forward less efficient proposals. Our rationale is that finding further efficiency gains during

the period will be harder for a company already deemed to have been at the frontier than one assessed to have been less efficient. A strong in-period efficiency incentive both acts as a further spur to management teams to find additional ways to deliver outputs for customers for reduced cost, it acts as a mechanism to “keep people honest”, in that, with symmetrical incentive rates, a company that has earned the right to have a higher sharing factor, is exposed to more of any increases in costs, should their cost forecasts turn out to be insufficient to meet the requirements to deliver all outputs. Similarly, a weaker sharing factor, typically informed by how the company had performed in the benchmarking of its business plan, provides greater protection for that company if costs rise above baseline allowances, and importantly, protects customers from that company catching up to the better performing companies in the sector and retaining a disproportionate share of that catch-up.

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

We welcome proposals to review and potentially streamline the minimum requirements used by Ofgem in its Stage 1 Business Plan Incentive assessment. There should be a clear rationale for each requirement, with subsequent transparency over how licensees have performed against each requirement – we believe this would help drive improvements in the quality of information provided by licensees and provide transparency to stakeholders.

We agree that the focus of this stage of Ofgem’s assessment should be on completeness and do not believe that an undue focus should be placed on a more nebulous concept of “quality”. Our rationale is that focussing on quality, with the scope to “decide what type of information best supports their proposals”, would make licensees risk averse – i.e. better to have submitted 100 pages of supporting documentation, when 30 would have sufficed.

We welcome Ofgem’s intention to provide “more targeted and specific minimum requirements for areas of the business plan that are essential for the setting of the price control”. We agree with Ofgem that failure of this stage should carry a penalty. To make this prospect more of a reality, we believe some form of traffic light or grading system is required – possibly akin to a driving test. For example:

Assessment against minimum requirements	Outcome
No failures	No penalty
Small number of minor failures (say less than 10% of requirements failed)	No penalty
Multiple minor failures (more than 10%)	Penalty of appropriate scale
Major failure of one or more requirements	Penalty of appropriate scale

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

We do not believe that the confidence-dependent incentive rate (CDIR) approach used at RIIO-2 was an improvement on the previous regulatory approach used by Ofgem – namely the Information Quality Incentive (IQI).

We believe an “in the round” assessment of cost forecasts, combined with the earlier steps of the BPI process, namely meeting all the minimum requirements, determining whether any proposals go above baseline expectations, should enable Ofgem to undertake a robust benchmarking assessment without the need to split costs into “high” and “low” confidence categories.

Ofgem’s approach to benchmarking in the Electricity Distribution sector, has historically taken certain types of costs which might be more bespoke for individual DNOs, out of the benchmarking for separate assessment. We are comfortable with this approach, subject to there being rigorous requirements applied, to ensure licensees are benchmarked on a consistent basis. Adding back any separately assessed costs does not need to alter the company’s sharing factor. Particularly not when considered with the other regulatory protections in place such as PCDs, reopeners and the RAM.

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

We agree with your preferred option of removing CVPs completely.

We do not believe the cost ambition assessment should be confused with an ambition assessment. The cost ambition assessment can be done quantitatively with clear and unambiguous outcomes. Conversely, the ambition assessment is far more qualitative and potentially subjective. We are concerned with how an “in the round” assessment attempting to combine these two very distinct assessments would play out in practice. Making qualitative adjustments, upwards or downwards to the cost ambition assessment could result in one of the least efficient companies earning the highest overall reward – we do not believe this would be in customers best interests and would question how effective any “publicity” that Ofgem give to such an outcome would be interpreted by customers and stakeholders.

This view is backed up by the experience of RIIO-ED2 where the requirements for successful award of CVPs was not clear and resulted in very limited impact given the work involved to produce them. This was evident in the inconsistent results for CVP rewards with our comprehensive CVP on Consumer Vulnerability not being rewarded whilst several DNOs received rewards for narrower proposals in the Consumer Vulnerability space.

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

RIIO-2 saw markedly lower business plan rewards than prior price controls. As noted in our response to OVQ28, considering our experience in RIIO-ED2 we remain concerned that licensees may believe there is a limited prospect of the downside penalty for providing inflated cost forecasts being applied. Combined with a relatively small upside reward and no real differentiation in sharing factors, we do not believe that the package is sufficiently strong to encourage all licensees to put forwards efficient business plan forecasts.

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

We believe Ofgem is on the right track with seeking to evolve the BPI. As noted in our responses to the associated questions, we are in favour of a clear set of minimum requirements with associated penalties for material failures. We agree with the proposed removal of CVPs. We favour a clear BPI reward based on cost ambition, not diluted by a qualitative ambition assessment.

**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?**

As set out in our response to OVQ30, we believe that the IQI is a better framework for setting sharing factors than the CDIR approach. The SSMC contains the following statement:

*“We note that, although information asymmetry is intrinsic to any price control (as regulators rely on company information to set allowances) arguably the CDIR addresses this more directly and, in this respect, represented an improvement relative to the IQI”.*

We do not agree with this statement. Our comparative assessment of the outputs from the RIIO-ED2 cost assessment under the RIIO-ED1 IQI methodology indicates there would have been a greater spread of sharing factors – 54.4% to 59.5% and a significantly higher up-front reward for the most efficient DNO group, in the region of three times the size of the RIIO-ED2 reward. Ofgem’s cost assessment toolkit is extensive and provides it with ample opportunity to discern the degree to which it accepts the cost forecasts from licensees, which then feeds through into the overall benchmarking assessment. There is no clear need, at least in the electricity distribution sector, to complicate the process with the CDIR approach, when simply translating the results from the cost benchmarking into sharing factors will suffice.



We are in favour of a continued symmetrical approach to the setting of sharing factors and do not advocate adoption of Ofwat's PR24 approach.

As a key in-period incentive, we believe the TIM sharing factors should be assessed separately for each price control and each sector. We are not supportive of the suggestion to "lock in" sharing factors from the RIIO-2 price controls as this removes a significant lever that Ofgem has to influence the quality and cost ambition of RIIO-3 business plans.

### **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?**

Yes, we agree. There is clear uncertainty with respect to government's heat policy, therefore this uncertainty mechanism will provide flexibility in response to a policy direction being set, which is scheduled to happen by 2026.

#### **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?**

Retaining this in principle is sensible as it is this type of development work that can help inform wider policy decisions and Ofgem's network company re-opener decisions.

#### **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?**

No response.

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

Combining reopeners appears attractive at face value and could aid with streamlining future price controls. We believe each proposal for combining existing reopeners should be assessed on its merits, to ensure that the new combined reopener affords both customers and licensees the necessary protections and sufficient thought is given to how assessments of future submissions will be undertaken and subsequently reported on.

#### **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?**

Yes, we believe the Coordinated Adjustment Mechanism (CAM) should be retained.

Notably the CAM has not yet been utilised by network companies in RIIO-2. Our view, however, is that the establishment of the National Energy System Operator (NESO) will increase the potential use of the CAM. Up to now there has been a lack of accountability to undertake cross vector optioneering, which compares options from different networks. With the creation of a publicly based NESO that will change, and they will be able to make impartial assessments on whether following policy or market developments there is a case for transferring outputs and allowances from one licensee to another. The NESO will be in place to ensure that the CAM can function properly should it be justified. We would welcome further consultation by Ofgem on how the CAM licence conditions should be updated once the NESO is up and running.

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

Yes, this makes sense, subject to their being no fundamental change with respect to reopener thresholds. I.e. in RIIO-ED2 physical security costs do not have a materiality threshold applied, whereas a number of reopeners do.

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

Yes, one overarching reopener is a good idea so long as it adopts £0m materiality to ensure the required flexibility for the individual elements is maintained, with multiple windows for network companies to apply and at the discretion of Ofgem to open at any time.

**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?**

Having recently seen an equivalent to the opex escalator introduced as part of the RIIO-ED2 price control, namely the indirect scaler, we are supportive of the proposed retention of the opex escalator.

We agree with Ofgem's intention to review coverage to ensure that there are no overlaps or gaps.

Similarly, we agree that the methodology should be reviewed to determine whether there are any improvements that could be made to both the calibration and operation of the mechanism.

Ahead of RIIO-ED3 we would expect a similar exercise to be undertaken and look forward to engaging with Ofgem, stakeholders and the other network companies in due course.

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

Any monitoring and operation of UMs should follow how mechanisms were treated in RIIO-ED2, where some would be appropriate for an annual assessment (i.e. volume drivers), milestone review (i.e. cyber) or an end of period assessment (i.e. UIOLI). We believe the arrangements built into the RIIO-ED2 price control reporting packs, particularly in the area of secondary reinforcement, provide a strong evidence case for the interventions being undertaken by licensees – or not as the case may be, where lower demand than forecast will be evident in the loading information provided to Ofgem.

As part of Ofgem's annual cost visits UMs should be a standing agenda item for all companies – both to explain what has happened in the year across the suite of UMs, and also to discuss the latest projections out for the remainder of the period. This should help tie the picture together with the forecasts presented as part of the Annual Iteration Process.

Ofgem's Annual Reports would be a good place to update customers and stakeholders on licensees' progress against UMs and for Ofgem to be able to articulate the key changes seen in the external drivers and needs behind the respective mechanisms.

In addition, we note that in our recently submitted Storm Arwen reopener claim we proposed arrangements to deal with the reporting and delivery assessment of the initiatives contained in our submission. Ensuring funding and outputs associated with UMs are appropriately captured and addressed is an essential element of ensuring the legitimacy of these regulatory mechanisms.

## **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?**

We believe that Real Price Effects (RPE) and Ongoing Efficiency methodologies should evolve for the RIIO-3 period. The key areas where it should evolve are:

- The application of RPEs and ongoing efficiency to costs should be consistent. In RIIO-2 ongoing efficiency was applied to all costs but RPEs were only applied to a proportion of costs. The treatment should be equalised for RIIO-3.
- The RIIO-2 RPE indices should be reviewed to understand whether current indices are capturing the cost pressures that each sector has faced over RIIO-2.

The RPE indices are updated annually whereas the ongoing efficiency assumption is fixed for the period. To address this mismatch in approach, if practical, ongoing should also be trued up annually.

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

It would seem sensible for both RPEs and ongoing efficiency to be applied to reopener costs to align treatment with ex ante costs.

## **Cyber Security**

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

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

## **Innovation**

**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?**

Innovation is an essential part of delivering the investment that will be required to facilitate the energy transition at lowest cost while maintaining operational excellence and the high standard of service our customers expect of us. If Ofgem can create powerful incentives similar to a competitive market, companies will naturally innovate to deliver efficiently and improve service to customers – potentially negating the need for ongoing separate innovation funding.

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

**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?**

Please see our response to OVQ47 above. Where separate funding is continued, we feel it is important that governance is appropriately robust to ensure focus on the agreed goals but, at the same time, does not introduce an unnecessary burden which could slow the pace of progress of innovative schemes.

**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?**

While we believe there is always room for improvement, we feel the current structure does not contain blockers to addressing whole system problems or aligning with other public sector initiatives.

**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?**

Please see our response to OVQ47 above.

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

We are always open to working with a wider range of third parties and welcome the wider insight that a broader group of partners brings. We do not see any specific barriers to working with third parties and have a good track record of running projects effectively led by non-network organisations. We believe this would continue even if separate funding for Innovation were not available as described in our response to OVQ47 above. We also welcome any proposals that can further support a wider set of providers participating and shaping innovative projects that benefit the energy system and ultimately current and future customers.

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

If funding is made more directly available to third parties, it is important to recognise that network companies will still have an important role to play. Developing an energy system that is reliable, efficient and meets the needs of our customers is a responsibility we take extremely seriously. It will be essential that all innovative projects are well aligned with these goals and given the best opportunity to be embedded if successful.

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

Please see our response to OVQ52 above.

**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?**

This is not an issue we have observed in projects we have launched. We assess the costs and benefits of our projects independently of price control boundaries and therefore the length of the price control would not influence our support of an otherwise well-justified project.

**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?**

We believe the FRS can be a key enabler for projects that test the boundaries of current regulatory frameworks and network codes. Therefore, we can envisage that innovation projects may make use of the FRS but that this would be identified on a project-by-project basis. An important feature of the FRS will be that the governance does not pose a barrier to the faster pace often required for innovative projects while maintaining the important consumer protections that regulation and codes are designed to implement.

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

The FRS will be particularly useful for projects that may otherwise not be permissible or require alternative approaches than under current regulations and codes. Current areas of interest include:

- Connections charging – how to make the connections charging rules work best to support connection of technology that will aid the country in the move to Net-Zero
- Network charges – how can ongoing network charges send the right signals and encourage the right behaviours to support the transition of the energy system e.g. encouraging flexibility.
- Network companies addressing market failures – strategic challenges often require arrangements that do not stack up under commercial business cases in the early stages of deployment. Network

companies may be well-placed to support nascent markets until proven and ready to deliver on strategic goals.

**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?**

We have well documented success in rolling out innovation projects. Across both the DPCR5 and RIIO-ED1 price controls we made major strides in rolling out proven innovation, with these benefits being seen by both DUoS and Connections customers through lower network expenditure, improvements in reliability and customer service as well as the speed and cost of connecting to the network. Importantly, this relates not only to projects we have led but innovations led by other network companies and adopting commercially available innovative technology and systems. These innovations are already showing significant benefits to customers.

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

The key to supporting roll out of higher risk projects is regulatory certainty. By providing consistent treatment of how costs and benefits are shared with customers, companies and the wider support network will have the confidence to invest in the wide-scale deployment of new technologies, systems and ways of working that will provide long-term benefit to customers and users of the energy system.

**Data and digitalisation**

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

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

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

If all sectors remained unaligned, as they are currently, then the approach used for those entering RIIO-3 first will differ for those sectors entering RIIO-3 at a later date (ED). For example, we could use Transmission as a base and make improvements/amendments based on experience. Alternatively, Ofgem may want to take elements of the current RIIO-ED2 reporting framework and seek to progress with modernising the regulatory reporting arrangements in those areas, whilst licensees in the Transmission and Gas Distribution sectors focus on their price control reviews. Whichever sectors and/or areas are selected, the scale of effort should not be underestimated, and timelines will need to build in sufficient scope for addressing unforeseen issues.

**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?**

All RIGs changes for the reporting year in question should be finalised and the CVR pack (or any other pack) should be issued no later than 31 March - this should be a hard deadline, i.e. whatever the pack is on 31 March is the pack to submit. In an ideal world, the cut off for making changes to reporting packs should be earlier – we would suggest pre-Christmas each year. This would afford licensees time to assimilate and disseminate changes to the regulatory instructions and guidance and conduct “dry runs” using part year data. Leaving changes till very late in the cycle reduces the opportunities for licensees to ensure systems and processes are generating data aligned to revised guidance and constrain Ofgem’s ability to engage with licensees on any issues ahead of submission.

RIGs development/changes working groups should start earlier in the regulatory year to facilitate this - or even post submission (i.e. these are working groups in the autumn to perhaps have final packs/guidance in Jan-Mar).

We welcome recent discussions with Ofgem regarding the intention to place greater emphasis on reporting and scrutiny of submitted data. We have found that annual visits by Ofgem to licensees have proven fruitful in terms of both aiding Ofgem's understanding and interpretation of data that has been submitted and licensees' interpretations and consistency of application of Ofgem's regulatory instructions and guidance.

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

In the electricity distribution sector, we believe that Load Related Expenditure should be an area of focus, given the suite of Uncertainty Mechanisms in this area, covering high volume, lower value activities such as secondary network reinforcement of transformers and circuits as well as low voltage service activities and the work associated with lower volume, higher value primary network reinforcement. NARMs would be another area of potential focus, given this is a high-cost area and the reporting framework is relatively straightforward, albeit significant in terms of the number of entries provided in the annual regulatory submissions.

Given the desire to "drive higher service standards across the areas that matter most to consumers", we would be supportive of looking at a number of the high-profile incentive areas within electricity distribution, such as the IIS and BMCS as part of the modernising project.

Whichever areas are ultimately selected, we would welcome ongoing engagement, particularly in terms of working through the practicalities of how licence compliance and data assurance activities will be undertaken in a world where submissions move away from excel based templates.

## Finance Annex Questions

This response is supported by the following reports:

- NERA, Additional Cost of Borrowing for the RIIO-3 Price Control
- Frontier Economics, Initial consideration of break-even inflation for price control purposes
- Oxera, RIIO-3 cost of equity
- Frontier Economics, Equity Investability in RIIO-3
- Frontier Economics, The low beta puzzle

These reports provide some of the detailed evidence in support of our positions and have been submitted to Ofgem alongside the ENA response.

### **FQ1. Do stakeholders consider there to be good reasons to deviate from the overall approach set out under UKRN Recommendation 8?**

We agree that:

- Setting the cost of debt allowance on a notional company basis based on the sector average debt costs remains appropriate; and
- The IBoxx Utilities 10 yr. plus index remains an appropriate index to assess the sectors' average debt costs against

In addition, we would support Ofgem seeking to maintain consistency in the length of the trailing average length across price control periods. This would avoid previously raised debt inadvertently being "off benchmark" if the trailing average period is altered.

In principle, the proposed RAV weighted cost of debt index would be an appropriate evolution of the price control framework. However, the calibration of the index can only be carried out post business plan submission. It is therefore essential that Ofgem engage with the relevant sectors on key decisions such as at what point the legacy RAV begins before publication of the Draft Determination for each sector.

### **FQ2. Do stakeholders have evidence in support of or opposition to one or more of the updated indexation or inflation remuneration methodologies under consideration.**

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

Ofgem have produced no evidence why breakeven inflation would be a better long run inflation assumption than the current approach of using the OBR Year 5 forecast. As noted in the Frontier report<sup>1</sup> critiquing breakeven inflation, it is derived from the market price differential between a nominal government bond and an RPI-linked government bond. There are a range of factors that may affect bond pricing including: inflation risk premium, liquidity premium, potential additional convenience premium brought by index linked gilt (ILG) over nominal gilt, and supply and demand dynamics in general which are unrelated to inflation expectations. As highlighted by Frontier the only relevant part of this differential is the inflation expectation, and it will be difficult to disentangle this element alone. Taking these points into account It is certainly not clear why this market measure should be preferred over reputable economic forecasts of the kind produced by the OBR.

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<sup>1</sup> Initial consideration of breakeven inflation for price control purposes, Frontier Economics, 5 March 2024

If Ofgem can robustly demonstrate that altering RIIO-2 inflation indexation approach is in customers' interests, then we believe that Option 1 would be a preferable option. With respect to the Option 1 and 2 the table below sets out an analysis of pros and cons.

**Table 1: Analysis of indexation Option 1 and 2**

Indexation option	Pros	Cons
<b>Nominal fixed rate cost of debt</b>	<ul style="list-style-type: none"> <li>• Better aligned to actual interest costs and hence there is a better match between revenue recovery and interest costs incurred.</li> <li>• Improves financeability in the short term</li> </ul>	<ul style="list-style-type: none"> <li>• Significant departure from existing real rate of return framework</li> <li>• Increase in customer bills in the short term</li> </ul>
<b>Inflate fixed rate debt proportion of the RAV by long run inflation</b>	<ul style="list-style-type: none"> <li>• Broadly maintains the existing rate of return framework.</li> <li>• No significant impact on customer bills in the short term</li> </ul>	<ul style="list-style-type: none"> <li>• No improvement in financeability</li> <li>• Continued misalignment between interest costs and associated revenue</li> </ul>

The table demonstrates that the advantages of one option are effectively the disadvantages of the other. The current expectation is that investment will need to increase in RIIO-3 to support the net zero transition and it is reasonable to assume that debt will need to increase fund this investment and hence interest costs will also increase. Under Option 2 the recovery of these costs will be back end loaded and hence in terms of inter-generational equity Option 1 may be a more appropriate solution.

Given that inflation impacts a number of areas of the price control in will be essential to ensure that if one of Option 1 or Option 2 are implemented there are no unintended consequences in other elements of the price control framework.

**FQ3. Do stakeholders have views on the potential approaches to implementation of the proposed methodology changes, including assumptions relating to ILD weights?**

Ofgem correctly highlights that an issue with their proposal to remove index linked debt from the notional capital structure is that it may have a negative impact on financial resilience. A key concern is how the credit rating agencies will adapt their metric calculation principles if Ofgem changes its methodology in this area. Currently credit rating agencies give credit for accretion in their calculation of interest cover ratios based on the fact that RAV is indexed by outturn inflation. It will be important for Ofgem to engage with the credit rating agencies to understand the implications of any proposed change in this area.

Furthermore, as Ofgem recognise it is vital that, if the level of index debt in the notional company is changed, an appropriate transition period is determined. If a single transition period is determined for each sector, then those companies who have index linked financial instruments which go beyond that period then they must be appropriately remunerated to convert those instruments into nominal debt to prevent credit metric issues.

As noted in FQ1 a key principle of the RIIO framework is that the cost of debt allowance is set on a notional company basis. However, our interpretation is that Option C is effectively setting an element of the cost of debt allowance based on actual company capital structure which contradicts this principle.

Additionally, the choice of capital structure has always been a decision for management. However, under Option B, Ofgem are mandating that all companies must transition their actual capital structure to the notional company structure over a defined period of time which removes this management choice.



#### FQ4. Do stakeholders wish to propose any other alternatives that have not been proposed?

None at this stage.

#### FQ5. Do stakeholders have any additional evidence for us to consider in our review of the additional borrowing allowances or infrequent issuer premium?

The NERA report<sup>2</sup> sets out additional evidence on the required cost of borrowing for RIIO-3. Based on NERA's analysis the additional costs of borrowing needs to increase to 71bps (including small company premium). The table below sets out the required costs and the rationale for the increase:

**Table 1: Additional borrowing costs for RIIO-3**

Units: bps p.a.	Ofgem RIIO GD/T2 & ED2	NERA (Feb 2024)	Comment
Transaction Costs	6	6	• Based on updated companies' data
Liquidity/RCF Costs	4	13	• Both Ofgem and NERA draw on companies' assumptions on RCF size and cost, but we assume 15% of RCF drawn to fund working capital/ operational needs • Increased liquidity cost also reflects higher short-term borrowing rates at RIIO-3
Cost of Carry	10	12	• Two approaches: i) companies' cash and debt in latest RFPs (12 bps), consistent with Ofgem's approach at RIIO-2, and ii) assume 12–24-month pre-financing, half met by RCF (range 8–16 bps)
CPIH Premium	5	18–23 (21)	• Ofgem recognised CPI switching costs of 5 bps p.a. (30 bps for new CPI debt, and 15bps for switching RPI-CPI, weighted by ILD%) • We estimate 30–50 bps p.a. for new CPI issuance using latest nominal-CPI swap costs, and 15 bps p.a. for managing RPI-CPI basis risk. Ofgem does not recognise CPI-CPIH basis risk cost, which we estimate to be 40–50 bps p.a. based on 1 st. dev. • We estimate the total cost for CPIH basis risk mitigation to be 18–23 bps p.a., by weighting the above estimate with 30% ILD, and new/embedded debt respectively
New Issue Premium (NIP)	0	5	• Latest market evidence supports a 15bps NIP, consistent with CAA for HAL. Multiplying 15bps with 35% assumed new debt% results in ca 5 bps p.a. of NIP
Additional Cost of Borrowing	25	54–59 (57)	
Small Company/Infrequent Issuer Premia	6	10–18 (14)	• Lower bound based on the CMS-implied premium, since CMS does not provide risk hedging for credit risk (Ofgem approach) • Upper bound based on illiquidity premium estimated using the bid-ask spread differential between sub-benchmark issues and issues at and above £250m
Total	31	64–77 (71)	

#### FQ6. Do stakeholders agree with our interpretation and proposed application of UKRN Recommendations 2-7?

The choice of the cost of equity is a critical decision for RIIO-2. It is generally acknowledged that the level of investment in electricity networks will need to increase to support the delivery of the 2050 Net Zero target. It is also recognised that the UK energy sector will need to compete globally for capital given that Net Zero investment is increasing worldwide. Consequently, the cost of equity, which is the incentive to invest, must be set at a level that will both retain and attract the necessary levels of capital. Regarding the latter we are concerned with Ofgem's "through the cycle" approach to the cost of equity. The implication of this approach is that a cost of equity for RIIO-3 could be set below the required level on the basis that it may have been set too high in the past or would be set too high in the future. If the cost of equity is set too low for RIIO-3 then it will impact the attractiveness of the sector to equity investors which in turn could impact the level and/or the pace in investment. This would not be in customers' interest.

The OXERA report<sup>3</sup>, prepared for the Energy Networks Association, determines a baseline cost of equity range for RIIO-3 based on the Capital Asset Pricing Model (CAPM). We agree that the CAPM should remain the principal method for determining the cost of equity range. The table below, taken from the report, sets out the RIIO-3 baseline cost of equity range calculated by OXERA.

<sup>2</sup> Additional cost of borrowing in RIIO-3, NERA, 22 February 2024

<sup>3</sup> RIIO-3 Cost of equity, OXERA, 23 February 2024

**Table 2: RIIO-3 cost of equity estimation at 60% gearing.**

	Formula	Ofgem approach range	Ofgem approach mid-point	Oxera approach range	Oxera approach mid-point
RFR	[A]	1.32%	1.32%	1.84%	1.84%
TMR	[B]	6.25–6.75%	6.50%	6.50–7.50%	7.00%
Re-levered equity beta at 60% gearing	[C]	0.70–0.82	0.76	0.70–0.82	0.76
<b>CAPM CoE</b>	<b><math>[K_e]=[A]+[C]\cdot([B]-[A])</math></b>	<b>4.75–5.77%</b>	<b>5.26%</b>	<b>5.08–6.48%</b>	<b>5.78%</b>

The key differences of the OXERA approach to the Ofgem RIIO-2 approach are:

**Risk Free Rate (RFR):** The inclusion of a convenience premium in the calculation of the RFR and the inclusion of inflation swaps information in the calculation of the wedge to convert from RPI index linked gilts to CPIH real RFR estimates.

**Total Market Return (TMR):** The use of:

- The ONS CPIH backcast data to deflate the historic nominal TMR.
- Arithmetic rather than geometric averages to calculate the TMR.

With respect to the TMR, the rationale underpinning Ofgem’s “through the cycle” approach is that the TMR should be stable across price control periods. However, stable does not mean fixed. This is supported in the UKRN guidance which recognises that there is benefit in maintaining the stable TMR approach but also states:

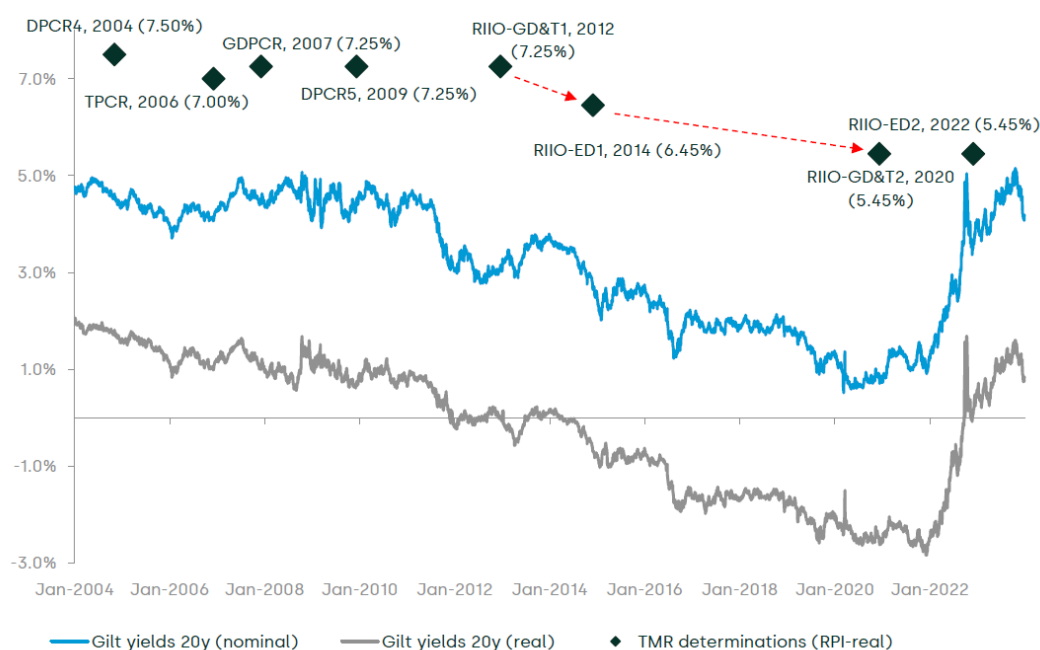
*“This approach does not imply that regulators should simply pick the same fixed value for the TMR in each decision for all time, but that the TMR would be relatively less variable than the underlying RFR”.<sup>4</sup>*

The figure overleaf shows a time series comparing the movement in gilt rates to Ofgem’s decisions on the TMR across a number of price controls. It is obvious from the figure that Ofgem responded to the decline in gilt yields in the period 2010–21 by reducing the TMR allowance (in RPI-real terms) from 7.25% in 2012 to 6.45% in 2014 and 5.45% in 2020. This illustrates that Ofgem responded to the decline in gilt rates by reducing the TMR.

As OXERA notes long-term gilt yields have reached levels last seen during 2005–11. Given that the TMR was between 7.0% and 7.25% (RPI-real) during that period, a consistent regulatory approach over time implies an increase in the TMR assumption in RIIO-3, to take account of the higher interest rate environment. 7.0% and 7.25% RPI-real estimates would be equivalent to a TMR between 8.07% and 8.32% in CPIH-real terms. OXERA’s ex post TMR estimate of 7.0% would be a relatively small change in the context of the observed increase in the UK government gilt yields. It would be a less significant change in the TMR compared with Ofgem’s response to such changes in interest rates in the past, while also being consistent with the view that the TMR is broadly stable.

<sup>4</sup> UKRN (2022), ‘UKRN guidance for regulators on the methodology for setting the cost of capital’, p.19.

**Figure 1: TMR determinations and gilt yields (RPI-real)<sup>5</sup>**



Additionally, on the TMR we would note that OXERA's analysis demonstrates that ex-ante TMR approaches produce results that are susceptible to hindsight bias and hence we agree with their recommendation that little weight should be placed on them.

**Beta:** In developing its view of the appropriate asset beta for energy networks OXERA has calculated values for National Grid, listed UK water companies and replicated Ofgem's RIIO-2 combination of both National Grid and UK water companies' betas. In addition, OXERA recommends that the beta dataset should be extended to include European energy networks which we agree with. In deriving the RIIO-2 estimate Ofgem used the National Grid 10-year betas and the combination of 70% National Grid and 30% water company betas to produce an asset beta range of 0.323-0.373, with a midpoint of 0.349. The mid-point from OXERA's analysis, utilising this approach, is 0.352 which is in line with the RIIO-ED2 value of 0.349.

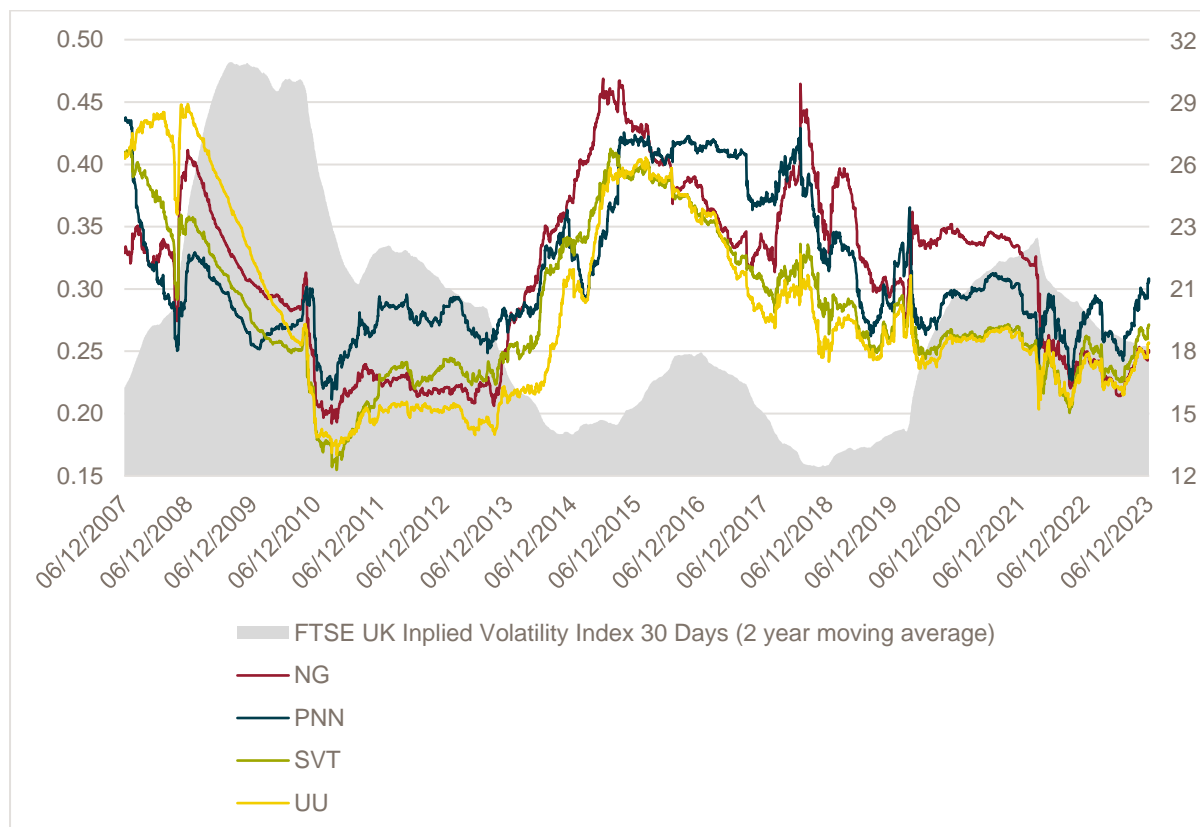
One issue that Ofgem should consider is the impact of recent market volatility on shorter term beta estimation. In its report for ENA<sup>6</sup>, Frontier Economics observes that utility betas tend to be negatively correlated with market volatility, implying that utility beta levels decrease when market volatility increases. The figure overleaf shows estimated betas over a rolling 2-year estimation window alongside market volatility derived from a 2-year moving average of the implied volatility index derived from options. It illustrates that in periods where market volatility has been high, betas of the four UK listed utility stocks are low.

This is an issue that Ofgem may need to consider when choosing a beta estimate for RIIO-3. As Frontier notes if volatility levels continue to tail off then 2-year estimates may prove potentially less problematic down the line, subject to the usual due diligence around potential distortions.

<sup>5</sup> Figure 2.6, RIIO-3 Cost of equity, OXERA, 23 February 2024, page 54.

<sup>6</sup> The low beta puzzle – A report prepared for the ENA, Frontier Economics, 5 March 2024

**Figure 2: 30d implied volatility and (unlevered) utility betas estimated using a 2-year estimation window**



As we have highlighted earlier the electricity sector will be facing an increasing investment challenge in RIIO-3 and beyond. These risks will be reflected in investors' perception of the risks associated with investing in electricity networks and therefore in the levels of return that they expect. There may be a need to increase the regulatory allowed beta, relative to RIIO-2, to reflect these increasing risks.

It is important to note that the consideration of these risks was not included in the scope of the OXERA report for the ENA. RIIO-3 business risk may not be adequately captured within those cost of equity estimates. We would expect to include evidence of the increasing risks for electricity distribution as part of the RIIO-ED3 process.

With respect to the use of cross checks, our view on this area is detailed in the response to FQ14.

**FQ7. Do stakeholders consider there to be good reasons to deviate from the respective approaches set out under UKRN Recommendations 2-7?**

Please see our response to FQ6 above.

**FQ8. Do stakeholders agree with our proposed methodologies where not specifically covered by the UKRN Guidance recommendations or our approach in previous price controls, such as the proposed approach to converting the RPI-real yields to CPIH-real inputs in the RFR calculation?**

Ofgem's proposed use of a geometric average to calculate the RPI-CPI wedge looks sensible. However, in addition to this approach Ofgem should also consider the post 2030 RPI-CPI wedge implied from the analysis of inflation swaps and for the long run wedge between CPI and CPIH set out in the OXERA RIIO-3 cost of equity report.<sup>7</sup>

<sup>7</sup> RIIO-3 Cost of equity, OXERA, 23 February 2024, page 32.

**FQ9. What comparators and/or timeframes are likely to provide the most accurate estimate of beta for the energy network sectors on a forward-looking basis?**

Please see our response to FQ6 above.

**FQ10. Do stakeholders consider there to be good reasons to deviate from the respective approaches set out under UKRN Recommendations 1 and 9?**

We agree that the WACC should be based on a notional company financing structure. With respect to gearing levels it is important that lowering the notional gearing is not seen as a financeability tool. We do not think this is appropriate. As noted in the UKRN guidance if Regulators lower the notional gearing from one price control to the next then they should consider whether the change is feasible. This would include assessing whether the cost of equity is sufficient to facilitate any required de-gearing.

**FQ12. Do stakeholders agree with the proposal that notional gearing levels should be maintained for each year of the price control? Do stakeholders have a preference for how this assumption is managed within the price control process?**

We believe the proposed approach may result in an unnecessary complexity in the price control process. For example, if the totex profile is front end loaded then a fixed notional target in each year could result in equity issuance cost being required in the early part of the price control period that would not be required if the notional gearing is allowed to flex through the period.

**FQ13. What, if any, improvements should Ofgem make to the assessment of financeability in the next price control?**

With respect to debt financeability we believe that Ofgem should:

- Specify the target credit rating it believes equates to comfortable investment grade i.e. whether it is Baa1/BBB+, BBB/Baa2 etc.
- Undertake longer term financeability analysis to understand future pinch points – we understand the assumptions used to generate this analysis cannot be seen to fetter GEMA's future discretion.
- Work with the companies to develop credible downside scenarios to stress test the price control financial outcome.

**FQ14. What evidence, if any, should Ofgem consider in relation to expanding its assessment of financeability to account for 'investability'?**

We support Ofgem's proposal to look at investability as part of the RIIO-3 financial framework. As we have previously mentioned the twin impacts of the required investment to support the delivery of the 2050 Net Zero target and the significant change in macro-economic environment means that setting an appropriate cost of equity is vital.

In its report for the ENA, Frontier Economics<sup>8</sup> has highlighted two specific tests for investability. They are whether the RIIO-3 return on equity:

1. Is sufficiently different to the return on debt given the different risk profiles; and
2. Is comparable with returns on comparable investment opportunities, and other cost of equity cross-checks, including those used by Ofgem at RIIO-2.

With respect to (1) there are two possible approaches; the hybrid bond cross check developed by Frontier and the Asset Risk premium (ARP)-Debt Risk premium (DRP) cross check developed by

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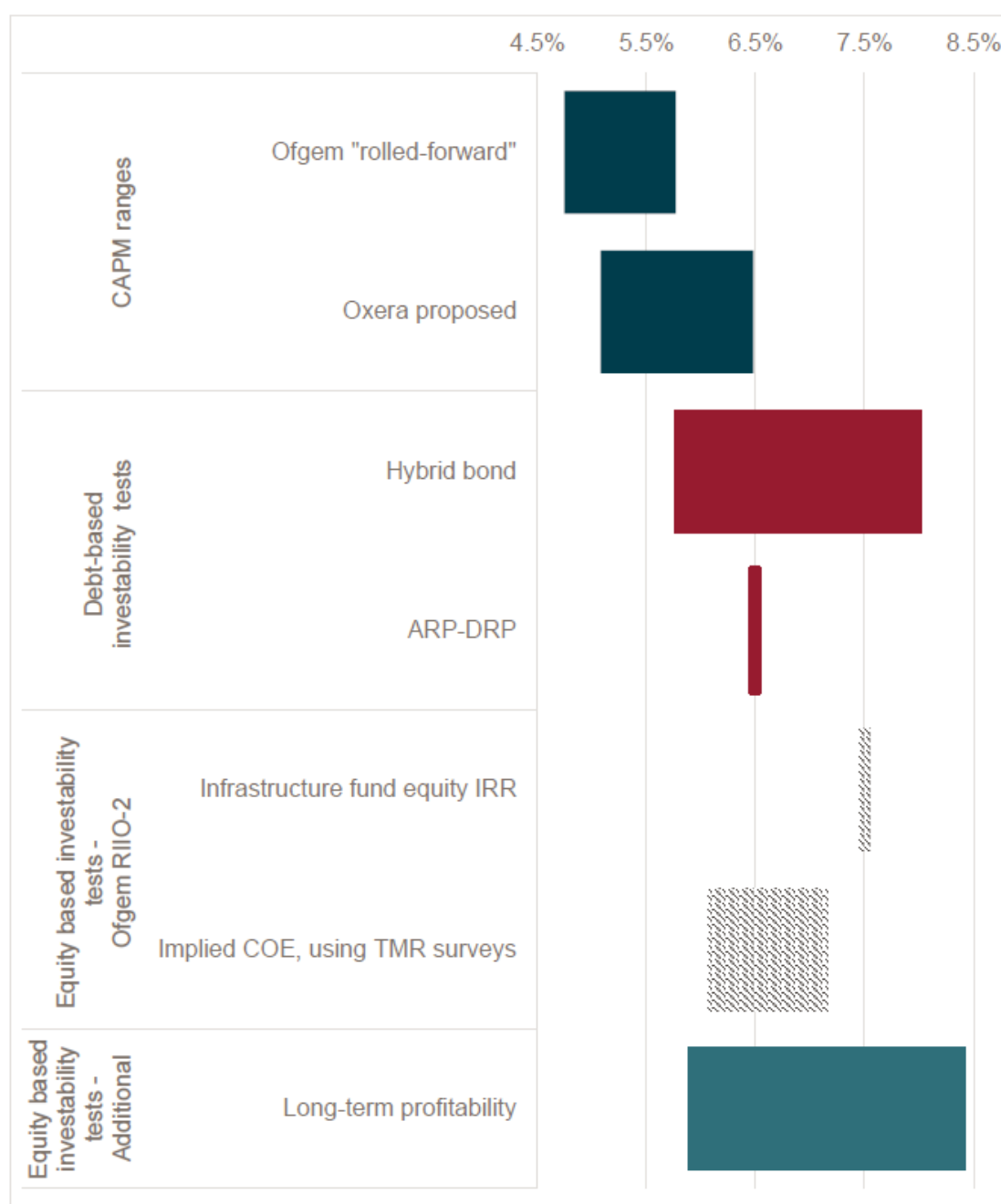
<sup>8</sup> Equity investability in RIIO-3, Frontier Economics, 28 February 2024

OXERA. For Option 2, where practical, Frontier have updated the Ofgem cross checks used at RIIO-2 and refreshed the long-term profitability cross check that they proposed at RIIO-2.

The table below, taken from the Frontier report, sets out a comparison of:

1. The roll forward of the RIIO-2 cost of equity methodology for RIIO-3 from the OXERA report.
2. OXERA's calculation of the baseline cost of equity for RIIO-3
3. OXERA's calculation of ARP-DRP differential
4. Hybrid bond cross check
5. Ofgem's RIIO-2 cross checks; and
6. Long term profitability cross checks

**Table 3: Investability test comparison**



We remain of the view that cross checks have limitations and care must be exercised in their application to determining the cost of equity. However, at RIIO-2 Ofgem did place weight on cross checks such as the infrastructure fund equity IRR and the implied COE, using market based TMR forecast as evidence that in using the mid-point of its RIIO-2 cost of equity range it was not setting the cost of equity too low. The above analysis would indicate that if Ofgem were to adopt the same approach a simple roll forward of the RIIO-2 cost of equity approach would result in a cost of equity that was too low and hence would fail the investability test.

**FQ15. What is your view on the proposed financial resilience measures? Are these appropriate and/or are there any other measures that you would propose?**

As Ofgem notes it already has in place a very comprehensive set of obligations and mechanisms to manage financing, financial resilience and dividend distribution. These include board level obligations and key roles for companies' auditors. The current arrangements include financial resilience reporting requirements that impose additional requirements on any companies that fail to meet certain resilience criteria.

With respect to the proposed amendments to this framework we already have more than one issuer credit rating. With respect to the addition of a gearing cap into the dividend lock up mechanism we can see a rationale for this, subject to understanding the detailed mechanics of how the gearing will be calculated for the cap. However, the requirement to have sufficient financial resources to cover a minimum of three years or an entire price control requires additional clarification. For example, if this measure requires companies to have committed facilities to cover 100% of forecast liquidity requirements for an entire price control period this will substantially increase liquidity costs and hence the additional costs of borrowing. It would be helpful if Ofgem could provide further detail in this area ahead of the RIIO-GD3/T3 SSMD.

With respect to the proposed new requirements on financial disclosures and dividend policies we will respond to the Regulatory Financial Performance Report (RFPR) consultation. However, as we stated in our response to the Call for Input the regulatory framework is complex with the timing of cash flows often misaligned with the timing of the performance/circumstances that drive those cash flows. Investors prefer a stable profile of dividend payments and hence companies will seek to smooth the profile of payments to achieve this. Caution must therefore be exercised when looking at a single year's payments as there will not be a perfect match between outperformance delivery and the profile of dividend payments.

**FQ17. For the SSMC we have not proposed dividend controls or dividend policy requirements. How should we think about protections to ensure that leverage at MidCo and/or HoldCo does not become disproportionately influential in decision making at the licensee with the potential for negative outcomes for consumers?**

Please see our response to FQ15 above.

**FQ18. Is there merit in amending the RFPR RIGs to include requirements for Licensees to undertake stress-testing, and to provide the results to Ofgem, as in the Retail sector and as the Prudential Regulatory Authority / Bank of England does for banks, to test for financial resilience?**

We do not think this is necessary as Licensees already have to undertake financial adequacy assessments as part of Licence Condition 30 compliance.

**FQ19. Do you agree with our proposal to align the RIIO-3 tax approach with RIIO-2 and ED2 including; to maintain Option A - notional allowance with added protections; the approach to capital allowances, and "glide path"?**

Yes, we agree.

**FQ20. Do you agree with the proposed revision to tax clawback methodology?**

In principle we can see the logic of aligning the treatment of accretion associated with index bonds and index linked derivatives.

**FQ30. Is there a case for altering the capitalisation rate modelling approach between sectors (e.g. removing the multiple bucket approach for GD)?**

For electricity distribution there is no evidence that the current approach is not working. However, this should be reviewed again as part of the SSMC for RIIO-ED2 when we have more experience of the current RIIO-2 framework.

**FQ31. What are your views on retaining an ex-ante capitalisation rate for allowed totex, but reporting an outturn capitalisation rate for the purpose of calculating the totex incentive mechanism?**

We believe that there is no evidence that the current ex ante mechanism is not working and therefore would question the benefit of adding additional complexity in this area.