Response to Ofgem's RIIO-3 Sector Specific Methodology Consultation for Gas and Electricity Transmission

KEY POINTS

- Ofgem's decision to evolve and improve the RIIO framework is right – key policies should be geared to **optimise the balance between investability, acceptability and deliverability.**
- **Ofgem needs to be bolder and braver - running the same playbook will not work.**
  - In RIIO-ED2, Ofgem's restriction of baseline allowances to meet only the least ambitious decarbonisation pathway **undermined deliverability of higher investment pathways**.
  - **Deliverability is further undermined by** the need to operate over 30 **uncertainty mechanisms** that delay investment decisions, sometimes in the areas that need it most.
  - **Investor confidence has been seriously undermined** by a knee-jerk contemplation of clawback and/or reopening of established price controls in relation to inflation indexation.
- **Ofgem's renewed focus on investability is positive – and much-needed**.
  - Setting an **appropriate cost of equity to attract investment** is key to delivering Net Zero.
  - Financeability tests based on credit metrics protect only a debt investor's interests - that does not automatically mean that equity investor requirements have been met.
  - Ofgem's **debt indexation methodology has a proven track record of attracting capital.**
    - Stability has a value – Ofgem has not cleared the hurdle that shows the current arrangements are a detriment to customers over the long term.
    - A review of Ofgem's inflation assumption does not rule out the current approach.
  - The long-standing ring-fencing provisions in the energy sector provide a firm basis for Ofgem to be confident that companies are behaving responsibly in relation to dividends.
    - The existing mechanism already allows for Ofgem to require companies to look ahead further than one year when approving dividends.
- **To ensure current and future customer acceptability, affordability must be addressed.**
  - **Ofgem's 45-year asset life policy** coupled with increased investment for Net Zero is creating an **intergenerationally unfair outcome** where customers pay more overall.
  - The current long-term path of prices that will put **unprecedented strain on customer willingness to pay** – politically-driven **asset stranding becomes a major risk to investors**.
  - Ofgem has been 'kicking the can down the road' for ten years – it must face the issue.
- **Ofgem must do more to ensure the deliverability** of the entire transition to Net Zero.
  - Ofgem is right to choose a common pathway that is ambitious – but the associated cost assessment and funding regime must **ensure that delivering** that scenario **is achievable**.
  - Ofgem should set a level of ex-ante funding for load-related expenditure that **ensures the networks remain positioned to deliver on all credible future pathways to Net Zero.**
- **Investability**, **acceptability** and **deliverability** need **light-touch, incentive-based regulation**.
  - Ofgem must establish an **investment framework that is internationally competitive** at a time when the world's largest economies are actively incentivising inward investment.
  - Ofgem must release the full potential of the RIIO framework to drive better outcomes for customers, where **strong incentives encourage investment, efficiency and innovation.**
  - **Ex-ante allowances** are the **best** way to encourage **efficient deliverability** – they give much-needed clarity and drive solutions not known or proven when the deal was struck.
  - **Ofgem must be bolder and clearer** about decisions where uncertainty in the ultimate outcome is high – on the tough calls, more decision-making is required upfront.

1. Executive Summary

Ofgem's decision to evolve and improve the RIIO framework – rather than try to reinvent it – is the right one.

1. We see the general thrust of the consultation as being positive, largely because it marks a shift away from a period in which Ofgem has, to our mind, placed too much emphasis on institutional arrangements and potentially radical reform of regulatory mechanisms. In contrast, the consultation is more focused on making constructive and pragmatic adjustments to a framework that gives Ofgem everything it needs to drive the right outcomes, in particular to ensure that the sector enables the Net Zero transition in a way that works for customers.
2. Ofgem’s explicit focus on investability is particularly welcome – and much needed. We would suggest that Ofgem should consider that as one of three guiding principles as it considers all of its important regulatory policies. The other two are acceptability and deliverability. Without an effective balance between the three, a long-term sustainable push towards the low carbon economy will not be achieved.

Ofgem needs to be bolder and braver - running the same playbook will not work.

3. At its core, we see the critical issue as the need for Ofgem to regain its confidence in lighter-touch, incentive-based regulation, and to put that into practice. The last round of price controls crystallised several years of steady erosion of the reliance placed by Ofgem on the fundamentals of its own RIIO framework. That has resulted in increasingly burdensome mechanisms where incentives to drive innovation and efficiency are weaker, certainty on the required outcomes and availability of funding is lower, and the risk of retrospective adjustment is higher. None of these are compatible with the sector delivering the best outcome for customers, and certainly not with delivering a significant increase in investment over multiple price control periods.
4. There are lessons to learn from the recent past. Ofgem’s RIIO-ED2 decision to restrict baseline allowances to meet only the least ambitious decarbonisation was already looking behind the times before it had even been confirmed in the Final Determinations. The reasons for the cautious approach were clearly explained, but those reasons underplayed the extent to which the decision undermined deliverability of higher investment pathways. The framework ignored potential future risks to delivery of investment programmes in a faster-moving transition, as well as the scope for synergies between asset replacement and load related expenditure.
5. Deliverability is further undermined by the need to operate over 30 uncertainty mechanisms that delay investment decisions, sometimes in the areas that need it most. The increasing tendency for Ofgem to delay decisions that relate to critical investment is not in the interests of customers. That aggravates the problems baked in by an overall incentive framework that was deliberately calibrated to put less emphasis on the value of companies submitting challenging plans.
6. Since then, investor confidence has been seriously undermined by Ofgem’s knee-jerk announcement that it was contemplating clawback and/or reopening of established price controls in relation to inflation indexation. Reputations are gained slowly and lost quickly – and Ofgem must now send a clear and sustained signal that the investment commitment remains intact, and any changes to price controls will be robustly tested and subject to open consultation.

7. What is done is done, so the focus can only be on the next steps and doing the right things going forward. Therefore, we see it as positive that Ofgem has correctly identified some of the key flaws in the way it implemented the RIIO framework and set out several possible routes forward in its Sector Specific Methodology Consultation (SSMC). Provided it chooses the right options, it will be able to set price controls in RIIO-3 that deliver better outcomes for customers.
    a. Its intention to reduce the number of reopeners at RIIO-3 is positive. This must be done in a way that reduces the level of uncertainty in the price control to restore investor confidence. To do this Ofgem must be more decisive at the time of the settlement, further utilise upfront allowances and stand behind its deal.
    b. It is right to seek to strengthen the business plan assessment process and Ofgem should trust its instinct to drop subjectively judged quality assessments.
8. We note that there are some significant differences between the electricity distribution sector and the other energy network sectors; Ofgem must set sector specific price controls without undue precedent being set from other parts of the process. It is important that Ofgem strikes an appropriate balance between shaping the methodology specifically for GD/T3 and recognition that there are aspects of it that are likely to impact ED3. Sufficient consideration should therefore be given to distribution network operator (DNO) input to this process whilst acknowledging that the framework for ED3 will be considered as open and developed under its own separate process.
9. The task now is to discount the options that will not work well as early as possible, so that there is enough time to work through the detail on the right answer. Ofgem's decision to evolve and improve the RIIO framework is right – key policies should be geared to optimise the balance between investability, acceptability and deliverability. It can achieve this through *lighter-touch, incentive-based regulation*. In fact, we would go further; we think that is the only way it can achieve that outcome.

Ofgem's renewed focus on investability is positive – and much-needed.

10. There is no doubt that now is the time to take steps to boost the credibility of the UK framework. In doing so, Ofgem must place a high premium on investor confidence and regulatory stability.
11. Setting an appropriate cost of equity to attract investment is key to delivering Net Zero. Ofgem's rendering of financeability considers the debt investor[1] but that does not automatically mean there is appropriate remuneration or incentive for an equity investor. Returns must sufficiently reflect the risks network companies face compared to the market to attract investment.
    a. Ofgem should not depart from its long-standing principle of focussing solely on the notional company, as opposed to actual company financing. It is unclear how Ofgem would take this into account in financeability assessments.

[1] We do not accept Ofgem's rendering of the financing duty. Investability is not separate from financeability. The financing duty requires that there must be appropriate remuneration for equity investors as well as debt investors.

12. Real cost of debt allowances and inflation indexation are cornerstones of the regulatory regime that have a tried and tested, proven track record of attracting equity and debt capital to the sector. We support retaining them (i.e., a version of option 3).
    a. Stability has a value - Ofgem has not cleared the hurdle that shows the current arrangements are a detriment to customers over the long term. The consultation only provides high-level details on possible future approaches. Altering such a key aspect of the price control should not be taken lightly and needs to be considered in the context of the price control as a whole. Given the effectiveness of existing arrangements around inflation and Ofgem's approach to allowing for the cost of debt, there is much to lose if ill-considered changes are made.
    b. A review of Ofgem's long-run inflation assumption, under option 3, does not rule out the current approach. Ofgem has not been clear what is wrong with the CPI-H inflation forecast provided by Office for Budget Responsibility (OBR) that is currently used. The OBR was established by the UK Government to provide independent economic forecasts. In any case its long-run inflation assumption must be fit-for-purpose, credible and independent - inflation breakevens from index linked gilts are not. Instead, a more credible approach to deriving the inflation assumption must be found before a departure from the RIIO-2 approach is seriously entertained.
13. As a matter of principle, we are oppose unilateral and unjustified changes to inflation linkage of past investments included in RAV, doing so would unduly damage investor confidence.
14. For future Regulatory Asset Value (RAV) additions in RIIO-3 and beyond, options 1 and 2 would introduce untested hybrid complexity that may reduce investor appetite for the sector. A regime that is extremely rare globally – a regime that is part real, part nominal – could adversely affect the sector's attractiveness to investors.
15. The full indexation of RAV and the associated freedom for investors ability to choose how to finance their businesses creates an overall structure that has proven is highly attractive to investors – and that has been very beneficial to customers. A change of this nature risks reducing the energy sector's attractiveness relative to assets in other regulated sectors that retain inflation indexation of the entire RAV (both in GB and globally) at a time when there is strong global competition for capital in energy networks.
    a. Should any prospective changes be adopted for new RAV additions, investments under the prior system should gradually run-off, and be replaced by investments under the new system. Shorter transitional periods would be insufficient for such a fundamental change to the regulatory system.
16. For future RAV additions in RIIO-3 and beyond, we remain of the view that Ofgem's proposal to maintain its debt indexation methodology will deliver the best outcome (i.e., a version of option 3). Ofgem needs to prove there is clear customer benefit before it moves away from its current policy position.
    a. Weighting historical years by sector RAV additions, with allowances for re-financing, could be considered if they would materially improve calibration. However, this must not

undermine the general principle that Ofgem is attempting to establish a realistic high-level benchmark of the sector's actual expected cost of debt.

i. Any refinancing assumptions should have reference to the historical debt issuances that are still in issue for a sector, rather than solely being an arbitrary tenor assumption.

ii. Using an average tenor of 15 years, for example, could conceal an expectation of some debt issuances being potentially substantially older than this.

b. The UKRN's guidance does recognise that it is important to carefully consider the inflation assumption required to deflate nominal debt yields – but as well as saying Ofgem's RIIO-2 approach is acceptable, it also stresses that "early signalling and an evidence based-rationale will be necessary to manage the effects of a change in this area."

c. The consultation mentions using inflation breakevens from index linked gilts as one potential alternative approach to deflating nominal cost of debt data. However, these breakevens will incorporate an inflation risk premium that means they cannot provide direct evidence on expected inflation; moreover there is significant potential for gilts specifically to be distorted by gilt market-specific factors, such as the convenience premium on gilts, or potentially pension fund regulations driving purchases of particular types of government debt. At present the figures they give for inflation are so far above the expert consensus around longer term inflation that this must cast doubt on the credibility of the breakeven data for this purpose. Instead, a more credible approach to deriving the inflation assumption must be found before a departure from the RIIO-2 approach is seriously entertained.

17. To the extent option 1 or 2 are considered, e.g., for new investments, option 1 is a much stronger proposition. Although we oppose what we regard as a unilateral retrospective change to the funding of past investments, we recognise that Ofgem could legitimately implement one of its alternative options for new RAV additions with adequate notice and appropriate transition. Of the two options, option 1 is a significantly stronger proposition.

a. Under option 1, the overall hybrid effect would be an untested regulatory system; however, the individual elements (debt and equity) would at least be familiar to investors.

b. Option 2 would retain the disadvantage of slowed cashflows, through an essentially arbitrary deduction from debt interest being fed into RAV growth, without conferring any offsetting advantage to investors. This approach would, to our knowledge, be unique for a network investment regime, and would make GB energy networks a less attractive proposition for investment over the longer term.

The long-standing ring-fencing provisions in the energy sector provide a firm basis for Ofgem to be confident that companies are behaving responsibly in relation to dividends.

18. The current ring-fencing obligations give Ofgem everything it needs to ensure companies take long-term financial resilience into account when making any dividend. But there is room for Ofgem to make clearer their expectations in relation to those requirements, including the need for

companies to look further ahead than 12 months when processing the Availability of Resources certification.

Ofgem must run more robust financeability checks, such that they properly consider the range of plausible investment scenarios.

19. Ofgem's financeability checks were not adequate at RIIO-2 – it did not even test financeability of the pathways that its own funding cap would support.
20. Testing should look beyond the five years of the price control period to ensure the settlement leaves the company financeable in the longer term. Additionally, appropriate testing should be done in light of decarbonisation investment expectations and cover the range of potential pathways.

Affordability is an issue for future customers, current customers, and investors.

21. As Ofgem considers affordability, it must do so in a more sophisticated manner than it has done to date. There is more to affordability than considering the impact on today's bill for today's customer – although that is, of course, a significant factor. It has to include willingness to pay and be viewed through the lens of customers in the future as well as current customers.
22. Ofgem's 45-year asset life policy coupled with increased investment for Net Zero is creating an intergenerationally unfair outcome where customers pay more overall. The current long-term path of prices that will put unprecedented strain on customer willingness to pay – politically-driven asset stranding becomes a major risk to investors. Ofgem has been 'kicking the can down the road' for ten years – it must face the issue.
23. The issues that arise with regulatory depreciation in each sector are different, since there are wide differences in historical depreciation profiles, future investment plans, and expected asset longevity. Each sector should therefore be considered separately, in the light of the issues facing it.
24. For the Electricity Distribution sector, the current trajectory will see regulatory asset values grow significantly, as key indicators of a company's financial strength weaken. If left unchecked, the industry will be locked into a path of long-term increasing prices spanning multiple decades, to pay for investments that that were made long ago.
25. Accordingly, the profile of depreciation needs to be accelerated significantly in RIIO-3 and beyond to address the serious financeability, cost recovery and intergenerational fairness issues, caused by the misguided change from 20-year to 45-year asset lives in ED1. Ofgem must keep the depreciation policy under review and revisit the evidence again as part of RIIO-ED3 so that the issue has been properly considered and addressed.

Ofgem must do more to ensure deliverability of the transition to Net Zero.

26. Ofgem is right to choose a common pathway that is ambitious. By failing to define a common pathway in RIIO-ED2, Ofgem had to deal with a wide range of submitted pathways that created difficulties with cost assessment and cost allocation. A common pathway, along with co-ordination of transmission and distribution infrastructure plans, are vital for the economic development of

the whole system incorporating all investment drivers including future capacity, localised connections, and asset resilience. Therefore, defining a common scenario is pivotal for RIIO-3.

a. Ofgem must be cognisant of the fact that a common pathway is more complex than just LCT uptake numbers; Ofgem must consider all the parameters to ensure a greater level of consistency – a common model may be beneficial to this.

27. Our view has not changed - Ofgem should calibrate a level of ex-ante funding for load-related expenditure that ensures the network remains positioned, whatever scenario emerges in the period, to deliver on all credible future pathways to Net Zero.

28. The costs assessment and funding regime must then ensure that delivering an ambitious scenario is achievable. The period of reference must extend beyond the price control in question to ensure solutions are optimal for the path to Net Zero in its entirety, to allow for the enabling of decarbonisation at the lowest cost to customers in the long term.

29. Under the RIIO-ED2 regime there is, in effect, no ex-ante allowance for some of the most important load related activities. The price control contains a placeholder that will be over-written by a simple "volume x unit cost" calculation. This arrangement means that companies only face incentives to beat the unit cost (a good incentive no doubt), but face only a very weak incentive to manage volumes. And these incentives may be further distorted if allowed unit costs end up being too high or too low.

30. Moreover, there is an important "boundary" between these aspects of load-related expenditure and the rest of the cost base, with the consequential danger that opportunities to trade off costs and identify synergies are lost. If Ofgem is not willing to fund an ambitious scenario upfront, it must think more carefully than it has done to date about the interaction between the cost assessment, the associated baseline, and the suite of uncertainty mechanisms. Additionally, Ofgem must be cognisant of the impact of the chosen scenario on the non-load network investment plan – synergies can only be embedded into cost assumptions (to customer's benefit) when load-related funding is guaranteed.

Investability, acceptability and deliverability need lighter-touch, incentive-based regulation.

31. Customers have benefitted from outcomes created by a regime built on the sound foundations of light-touch, incentive-based regulation. Within electricity distribution these include lower costs, shorter power cuts, faster connections, and better customer service. Ofgem must release the full potential of the RIIO framework to drive better outcomes for customers, where strong incentives encourage investment, efficiency, and innovation. Ofgem must establish an investment framework that is internationally competitive at a time when the world's largest economies are actively incentivising inward investment.

32. The information and efficiency incentives at RIIO-ED2 weakened the incentive to reveal efficient cost information. A mechanism for rewarding subjectively judged value propositions combined with a lack of penalty for not submitting a challenging plan diluted the incentive to identify efficiencies, before they have been realised, and factor them into the cost forecast – in other words, commit to them up front. The discretionary assessment of bespoke projects further dilutes the incentive to find cost efficiencies through the period. Maintaining a similar architecture at RIIO-3 would not be in the interest of customers.

33. Ofgem has made matters worse by referring to the incentive mechanisms that are designed to encourage companies to stretch their cost assumptions, and back themselves to find ways to create the efficiencies before the costs are actually incurred, as the 'truth telling incentive'. The damaging inference that a plain reading of this description can create should be obvious to the team at Ofgem. Certainly, it can only increase the likelihood of unfounded legitimacy questions leading to reduced customer confidence. Leaving Ofgem's inappropriately loose language to one side, the best way to achieve transparent mechanisms that give clear and direct incentives would be through a quantitative and objectively robust mechanism such as the Information Quality Incentive (IQI).

34. The IQI's strength comes from how it harnesses the interaction between three elements, which come together to ensure that companies are better off submitting only necessary costs where the cost of delivery has been genuinely challenged. These three elements are:

    a. The cost assessment evaluation,

    b. The incentive rate, and

    c. The associated reward or penalty (called the additional income element in Ofgem's earlier iterations of the IQI, which was subsequently blended into the "interpolation with submitted costs" element in later iterations of Ofgem's IQI).

35. These elements act together to ensure that if a company submits a higher cost of delivery than it needs, it will be worse off than had it not done so. The overall effect must be carefully calibrated to ensure "incentive compatibility" and therefore that companies are encouraged to submit genuinely challenging plans, i.e., the lowest cost of delivery, while meeting (or potentially exceeding) all the output requirements Ofgem has set. The submission of challenging plans can then also help reveal other companies' relative inefficiencies.

36. Ofgem should make use of this financial incentive to help promote the provision of information that will reveal the true efficiency benchmark. In doing so, Ofgem should apply penalties and rewards such that they rise gradually to cover the efficiency spectrum. This will incentivise companies to think hard about where to locate their plans and discourage the submission of plans where costs and outputs have not been adequately balanced.

37. The incentive power of the regime needs to be bolstered to properly reward companies for improved performance, increasing productivity and lowering costs.

    a. Ofgem is right to consider its use of price control deliverables (PCDs) to have been excessive at RIIO-2. Its proposal to raise the bar for PCDs to ensure ring-fencing is used sparingly is sensible and it should ensure this ambition is fulfilled.

    b. Its proposed financial incentive framework will incentivise companies to perform well and signal investability. Financial Output Delivery Incentives (ODI-Fs) with scope for both rewards and penalties, alongside a wide exposure range and lower incentive rate will incentivise the best performance.

    c. We do not see the need for bespoke outputs. They result in an inconsistent incentive package and dilute the core output delivery incentives that carry the greatest value to consumers.

38. We have already highlighted that Ofgem must be bolder and clearer about decisions where uncertainty in the ultimate outcome is high. In practice, that means that, on the tough calls, more decision-making is required upfront. Ex-ante allowances, along with cost incentives, provide a powerful motivation for companies to seek, develop and deploy approaches and solutions that they were not aware of at the time the price control was struck. Ex-ante allowances are the best way to encourage efficient deliverability – they give much-needed clarity and drive solutions not known or proven when the deal was struck.

    a. If the plan can be beaten, then companies have every incentive to try. Customers benefit immediately if they succeed, as they take a share of any savings. They benefit further as new, more efficient solutions found through innovation will inform future price controls.

    b. Setting totex allowances avoids creating artificial barriers between cost heads. If there are trade offs and synergies to be found, companies face no impediment to pursuing them. Again, customers benefit in the short and long run.

    c. Without these incentives, the imperative to strive and search is markedly diminished.

2. Detailed responses to the questions

Future of Gas

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

39. Yes, the proposals appropriately consider the Hydrogen Transport Business Model alongside RIIO-3. How to manage the uncertain future of hydrogen is important.

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?

40. We have no additional activities to suggest.

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?

41. Yes, we agree with including any additional costs for hydrogen blending in the price control uncertainty mechanisms. The choice and design of the mechanism is best explored by Ofgem and the gas network companies.

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)?

42. The choice and design of the mechanism is best explored by Ofgem and the gas network companies.

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?

43. We agree with Ofgem's intended approach.
44. The National Infrastructure Commission Second National Infrastructure Assessment[2] published in October 2023 set out a range of recommendations to government on the infrastructure needed to boost the UK's hydrogen manufacturing and storage capacity and its role in supporting the UK's Net Zero goals. Importantly, it also recommended that 'there is no public policy case for hydrogen to be used to heat individual buildings. It should be ruled out as an option to enable an exclusive focus on switching to electrified heat.'

[2] Second National Infrastructure Assessment - NIC

45. In addition to this independent advice, government ministers have commented that they do not support hydrogen for use in home heating. The government announced in December 2023 that the proposed hydrogen heating village trial in Redcar could not go ahead as designed, as the main source of hydrogen supply would not be available. The similar trial for Whitby in Ellesmere Port had been the subject of an earlier cancellation.

46. Until the government has made its decision on the future of hydrogen in 2026 then customers should not pay for further innovation or roll-out of hydrogen for heating through their energy bills. If the government needs additional work to support its decision, then that should be covered through innovation funding routes that are separate to energy bills. Further, RIIO-3 should fund network investment or changes in spending as a result of the 2026 decision on hydrogen for heating through the Heat Policy re-opener proposed for gas distribution.

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?

47. On the basis that any significant decommissioning costs would fall after RIIO-3 it is reasonable that funding within the RIIO-3 price control period should be recovered through the proposed Heat Policy re-opener. Further the RIIO-3 innovation stimulus or Net Zero related uncertainty mechanisms should include for any costs relating to projects that create evidence or develop thinking for large scale decommissioning if required.

Roles of Scenarios and Planning Pathways

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

48. Yes, we agree that the Future Energy Scenarios (FES) framework is a suitable source of the scenarios to be used for RIIO-3. The FES is particularly suited for informing transmission network requirements because it employs a top-down approach starting at the transmission level. Similarly, the Distribution Future Energy Scenarios (DFES) is more suitable for distribution network planning since it uses a bottom-up approach, starting at postcode level, to derive highly granular forecasts.

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

49. Our position has not changed, planning against a single common scenario is essential to avoid the issues encountered with RIIO-ED2. A common scenario along with co-ordination of transmission and distribution infrastructure plans are vital for the economic development of the whole system, incorporating all investment drivers including future capacity, localised connections, and asset resilience.

50. The transmission network should be developed to accommodate any of the prospective scenarios. Leading the Way is suitable for planning transmission network needs in RIIO-3 because it represents the fastest credible decarbonisation pathway with significant electrification. The defined planning window near the start of the transition to low carbon energy means that

strategic investment in assets will not ultimately be stranded. By aligning planning with the ambitious scenario, which has the most distributed connected generation, the transmission network capacity should be there so that customers will avoid the connection delays and issues currently caused by the transmission constraints that we are now seeking to mitigate. Not only should network operators plan network capacity in accordance with the ambitious scenario, networks should be developed strategically in line with the associated requirements.

51. It is important that the cost assessment process and funding mechanisms must be appropriate for the scenario chosen.
    a. The period of reference must extend beyond the price control in question to ensure solutions are optimal for the path to Net Zero in its entirety, to allow for the enabling of decarbonisation at the lowest cost to customers in the long term.
    b. A common pathway is more complex that just Low Carbon Technology (LCT) uptake numbers; Ofgem must consider all the parameters to ensure a greater level of consistency – a common model may be beneficial to this.
52. Our view has not changed - Ofgem should calibrate a level of ex-ante funding for load-related expenditure that ensures the network remains positioned, whatever scenario emerges in the period, to deliver on all credible future pathways to Net Zero.
53. Where it can, Ofgem should make use of ex-ante funding for load-related projects, such that network companies are able to deliver on all credible future pathways to Net Zero. This will also incentivise electricity transmission networks to carry out investment at the lowest cost to customers.
54. Ofgem should have a high bar for introducing reopeners, only applying them where there is a clear trigger. Applying a reopener wherever there is cost uncertainty is to broad a description and risks inefficient delivery of investment.
55. Where implementing volume drivers, Ofgem should ensure the mechanism maintains strong incentives for networks to control their costs and that submissions facilitate consistent cost benchmarking.
56. Ofgem should give ex-ante allowances alongside volume drivers. There must be a degree of volumes that can be forecast to a relatively certain degree; ex-ante funding associated with this will give networks a strong incentive to find volume efficiencies alongside cost efficiencies. The volumes associated with the ex-ante allowance must be to a level that will allow for the enabling of a fast-moving pathway in future price controls beyond RIIO-3. Otherwise, the risk of disallowances will hold back investment and risk networks becoming a blocker if an ambitious pathway materialises.
57. Also, Ofgem must not forget that beyond a common pathway, a common set of uncertainty mechanisms set by Ofgem are also key to receiving a set of consistent and comparable business plan submissions. At RIIO-ED2 not only did networks plan according to different pathways, but also cut this differently between funding pots, causing issues in normalisation.
    a. The key to improving cost assessment, particularly in load-related expenditure, is to ensure that the initial submissions are completed on a consistent basis. This is dependent

on agreed reporting tables, supported by robust definitions and clear direction on key assumptions, such as decarbonisation pathways as well as funding mechanisms. Ofgem's move to the use of a common pathway will allow for significant improvement on RIIO-2; it must not forget that the lack of provision of a common set of uncertainty mechanisms caused significant normalisation issues at RIIO-2.

OVQ9. Do you agree with the proposal to use two FES planning pathways for the gas networks, ie Leading the Way and Falling Short as the additional common conservative scenario?

58. It seems likely that electricity will be used for most heating and transportation in the future. Therefore, it makes sense for the gas networks to prepare for this eventuality and base its planning on the Leading the Way scenario, which anticipates limited hydrogen use for heating. However, the rate of transition is still somewhat uncertain, so considering Falling Short as a sensitivity could be useful.

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?

59. The Falling Short scenario could be viewed as an extreme case for gas network planning sensitivity, since it does not achieve Net Zero and retains a heavy reliance on natural gas. The Falling Short scenario is widely used and therefore well-known, well understood and can be applied consistently.

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?

60. As they begin to develop the Centralised Strategic Network Plan (CSNP), the Future System Operator (FSO) will not use the scenarios on which the FES 2023 was based for the basis of the FES 2024. The transition from past scenarios and FES 2023's framework to pathways, counterfactuals, and sensitivities in FES 2024 may lead to differences between draft RIIO-3 plans and final plans. However, a plan to transition from FES 2023 to FES 2024, and the understanding that comes with it, should make it possible to update plans, acknowledging the additional effort required to re-evaluate network requirements under the new system.

61. It is sensible for Ofgem to ask companies to update business plans in line with the most up-to-date forecast, and the fact Ofgem is providing clarity on that requirement upfront means companies can adapt their planning processes to allow for that. However, in any world when asking for updated business plans, Ofgem must avoid allowing a resubmission at a point in the process that allowed companies to game the benchmarking. Robust benchmarking is more valuable than refreshed forecast data.

Outputs and Incentives

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

62. The application of PCDs leads to additional regulatory burden and distorts price control incentives to reduce costs. They should therefore be used sparingly, as they will ultimately result in higher costs to energy customers over the long term.

63. Ofgem is right to consider its use of PCDs to be excessive at RIIO-2. Its proposal to raise the bar for PCDs to ensure ring-fencing is used sparingly is sensible and it should ensure this ambition is fulfilled.

64. Ofgem should be sceptical of bespoke PCDs as these may reflect attempts to take costs outside of the cost assessment framework and business plan incentive arrangements (or its successor). We understand Ofgem's attempt to deal with this to be the requirement for companies to provide clear justification alongside its PCD application as to why the proposed allowances should be technically assessed as opposed to benchmarked. This will help, but Ofgem should make the evidence requirements more specific to ensure that only truly bespoke items are ring-fenced. These requirements would include:

    a. evidence that the costs are not correlated to any cost drivers typically used in the cost assessment, including when grouped with similar cost pots,

    b. evidence that the costs do not share cost trade-offs with any other cost category and are truly separable without creating distortions,

    c. evidence of the detriment to customers from sub-par, late or no delivery, and;

    d. any other evidence of the bespoke nature of the project.

65. A further step in Ofgem's process is also necessary, for any candidate bespoke PCDs that meet the above hurdles: to consult openly with other licensees in the same sector on the details of the proposed bespoke PCD to identify whether they are delivering anything that meets the same requirements. This may provide Ofgem with useful benchmarking information on lower cost approaches, and also whether potentially similar objectives are being delivered by other companies within business-as-usual costs (which would have implications for cost benchmarking).

66. We are supportive of the application of a substantial materiality threshold across all sectors. This will naturally reduce the number of PCDs, reducing the administrative burden and costs, and allowing Ofgem to focus its efforts on the monitoring of PCDs that have strong cases of material customer benefits that would not otherwise be funded through baseline allowances.

67. We agree that the output should directly contribute to RIIO-3 outcomes or the meeting of government legislation, standards or guidance. Ofgem is sensible to narrow the application of PCDs to cases where sub-par, late or no delivery would cause customer detriment, as opposed to awarding a PCD to any project that can be linked to achieving a customer benefit. This criterion raises the bar well, ensuring the negative implications associated with ring-fencing are only brought into the price control where delivery is crucial to customers.

68. We support the criteria that the outputs must be tangible with clear deliverables and timelines defined to ensure companies use the funding to provide the agreed customer benefit, and agree that these should be outcome focused to give the flexibility required to encourage companies to identify new solutions to deliver the outcome in the most cost efficient way. We believe this will lead to the use of evaluative PCDs over mechanistic PCDs; under its considered scoping for RIIO-3 Ofgem should not be setting any granular mechanistic PCDs where a company simply receives a unit cost for each volume laid down up to the agreed PCD volume total.

69. While the proposed focus on outcomes and application of the efficiency incentive to PCDs incentivises companies to deliver the project in the most efficient manner, Ofgem's narrowed scoping does not deal with a major drawback of PCDs, and instead encourages it. Requiring companies to go on to deliver the project or risk a PCD clawback or penalty through a licence obligation will remove incentives for companies to solve the problem in an entirely different manner. This will ultimately raise costs for energy customers. Even if companies identify some the potential risks to delivery alongside the submission for Ofgem to use as conditions where the penalty for no delivery is not applied, it would be impossible to cover all grounds for non-delivery being the most optimal solution and this disincentive will remain.

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

70. We are largely supportive of Ofgem's proposed framework for financial incentives.

71. The use of Return on Retained Earnings (RORE) to express the rates, caps and collars will incentivise companies to perform well to signal investability, and the ability to measure the strength of the incentive framework overall across a price control will help Ofgem maintain consistency across RIIO-3.

72. Ofgem has not however given clarity on the incentive exposure range – it would be helpful to debate the appropriate strength of the financial incentive framework as there was a large variety of incentive strengths across RIIO-2.

73. In most cases, financial rewards and penalties incentivise the best performance. Penalty only incentives can lead to 'bare minimum' outputs, whereas the scope for a reward incentivises companies to find improvements. A deadband should not apply before rewards start to be earned; a wider incentive range and lower incentive rate is preferable to a deadband to optimise performance.

74. Ofgem must set stretching but achievable targets. The targets should recognise historical performance improvements, whilst balancing the risk that it creates unachievable targets due to differences between companies and past (and potential offsetting) benchmarking imperfections. It should be mindful that whilst fixed targets help support collaboration and sharing best practice, evolving customer expectations mean fixed targets can be dynamic over time.

75. We would encourage Ofgem to set the methodology for its target setting in its Sector Specific Methodology Decision (SSMD), to allow licensees to build the cost of meeting a particular level of service in their business plans. This was the intended approach to the target setting and business planning process in RIIO. Where the approach has been followed in previous rounds of RIIO it has delivered significant benefits in terms of business plans that are higher quality and more comparable.

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

76. We agree that reputational incentives are a useful tool to hold companies accountable to business plan commitments through annual reporting, where the customer benefit is less tangible and data is insufficient, but improvements can be made beyond licence standards.

77. We would encourage Ofgem to consider the regulatory burden annual reporting imposes on companies and Ofgem, compared to the benefit of the Reputational Output Delivery Incentive (ODI-R).

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

78. We do not see the need for bespoke outputs, and believe they result in an inconsistent incentive package and dilute the core output delivery incentives that carry the greatest value to consumers.

79. If an output justifies incentivisation in one licence area to benefit those customers, it would almost certainly bring benefit to all customers and should be rolled out nationally to maintain a consistent incentive package across the whole country. Ofgem should therefore keep its focus on developing sector-wide outcome measures that benefit all customers.

80. It should also be mindful of the resource burden of bespoke outputs and, as explained in our response to OVQ12, maintain a high bar for applying any bespoke element in the price controls. A fragmented set of price controls will also be more difficult for Ofgem to monitor and manage.

81. Most if not all bespoke output candidates will by definition bring limited incremental value for consumers, as all material items will already be captured by the common, core outputs framework. Therefore the added complexity is unlikely to be worthwhile.

Outputs and Incentives – Environment

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

82. Yes, we agree. Maintaining these aspects of the environmental framework will support network companies to deliver an environmentally sustainable network.

83. The reputational incentive allows for increased transparency and awareness of the impact network activities have on the environment and the actions and plans to manage risks, improve performance and decarbonise.

84. PCDs are a useful tool in ensuring approved funding for projects that bring large benefits to customers is spent on such projects, but the application of PCDs to large projects within the Environmental Action Plan (EAP) requires caution from Ofgem. PCDs on environmental costs would increase the administrative burden for both Ofgem and the company. The resource burden introduced should be proportionate to the gain from the mechanism.

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

85. Ofgem's proposed consistent formatting across company reports will be a worthwhile improvement to environmental reporting. This template should be developed in collaboration with the industry to ensure consistency.

86. This will increase transparency and comparability, as well as keeping the focus on year-on-year improvements.

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

87. We support the retention of this reputational incentive to reduce business carbon footprints.

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

88. We have no specific views on this in the context of gas distribution and transmission.

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.

89. We agree with the proposal to withdraw the environmental scorecard ODI-F.
90. We believe the ODI-R is sufficient incentive to drive performance. Obligations under the Annual Environment Report (AER) are the appropriate driver to reduce environmental impacts arising from activities and facilitate decarbonisation of operations.

Q21. Do you consider that there are other areas which require financial incentives which cannot be captured by the AER? Please explain your reasoning.

91. We have no specific views on this in the context of gas distribution and transmission.

Outputs and Incentives – NARMs

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

92. We agree that in RIIO-ED2 Ofgem has had demonstrable success in improving commonality and consistency of the implementation of the Network Asset Risk Metric (NARM) methodology across all electricity distribution network companies.
93. In electricity distribution we consider that all the key components of NARM are fundamentally fit for purpose, including methodologies, NARM Funding Arrangement, license conditions, Regulatory Instructions and Guidance (RIGs), reporting packs, information gathering plans and good practice guides. RIIO-3 offers an opportunity to establish stability of reporting across price control periods which has not been possible whilst the frameworks have been evolving since being introduced ahead of DPCR5.
94. We therefore fully support Ofgem's intent to build upon the existing NARM frameworks within each sector. We are encouraged that Ofgem are looking to take advantage of what we consider to be a mature and stable framework in electricity distribution and will continue to support the development of consistency within other sectors with respect to the approach to NARM.
95. Maintaining these core components of NARM will not inhibit continual improvement and we support Ofgem's ambition to expand the coverage of the NARM methodology. It is important that this is done in a considered and proportionate way as to not undermine the existing framework

which has been designed around the availability and robustness of the data that is already available to the network companies, or may become available with the advent of new collection methods.

96. The use of NARM in justifying investment decisions played an important role in RIIO-2 for electricity distribution and we agree that this should continue alongside Cost Benefit Analysis (CBAs) and Engineering Justification Papers (EJPs) as part of Ofgem's wider assessment toolkit.

Outputs and Incentives – 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?

97. The principles for embedding climate resilience are sensible and reflect both the approaches laid out in the climate resilience strategies developed for RIIO-ED2 and the further work identified in these strategies and the Adaption Reporting Power 3 (ARP3) reports submitted to Defra.

98. Forward looking data such as UK Climate Projections 2018 (UKCP18) has already been used consistently across electricity distribution's approach to climate resilience and the availability of robust national projections means that this can be embedded within process in a common manner.

99. Climate resilience strategies should contain valuations for the costs and benefits of adaptation actions however it may be necessary for these to have defined timescales. Use of adaptation pathways will allow the evolution of the adaptation approach as projections are revised and we experience differing climate conditions however, this will also lead to changes is the costs and benefits anticipated over the longer term.

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

100. The approach laid out mirrors that implemented in RIIO-ED2 and hence will contribute towards cross-sector working through commonality and consistency.

101. Gaps and areas for improvement identified within the RIIO-ED2 climate resilience strategies and the ARP3 reports have been included within this RIIO-3 approach.

102. Whilst work is currently ongoing to create forward looking resilience metrics for electricity distribution for implementation in 2028, it would be prudent to ensure that this work is taken into account within any guidance that is issued as part of RIIO-3 for this area.

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?

103. We agree with the suggested approach for embedding climate resilience. The introduction of resilience strategies and climate resilience working groups mirrors the approach adopted for RIIO-ED2 and will support consistency within and across sectors.

104. Forward looking resilience metrics are currently under development within electricity distribution and this is being done in conjunction with the gas and transmission sectors. We therefore consider that the timescales for the implementation of these metrics should either align with those laid out for electricity distribution or be set further out to allow for commonality across sectors.

105. It is however important to note that there are other reporting frameworks in place which companies are required to report under (such as the Adaptation Reporting Power and the Companies Act – which now includes requirements for climate related financial disclosures) and it would be prudent to ensure that the requirements and timings of these are also considered within the RIIO-3 approach.

Outputs and Incentives – Resilience Metric

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

106. Forward looking resilience metrics are currently under development within electricity distribution and this is being done in conjunction with the gas and transmission sectors through the Energy Networks Association (ENA). We therefore agree that the timescales for the implementation of any resilience metrics should either align with those laid out for electricity distribution or be set further out, as suggested within the consultation.

107. The work being done within electricity distribution is complemented by work being carried out be Newcastle and Manchester Universities within the CS-N0W project, as well as the recommendations of the National Infrastructure Commission referred to within the consultation.

108. We agree with the implementation of both climate and wider resilience metrics as long as the relevant sectors and stakeholders are engaged in the process to ensure that reporting on the metrics is achievable and relevant.

Outputs and Incentives – Workforce Resilience

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

109. We support Ofgem's proposal to facilitate the industry's ambition to have a resilient workforce. We agree with Ofgem that it is not appropriate to set formal performance targets and reporting requirements in this area.

Truth Telling and Efficiency Incentive

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

110. We agree with Ofgem's objectives. Ofgem should look to meet these objectives through transparent mechanisms that give clear and direct incentives.

111. The best way to achieve this would be through a quantitative and objectively robust mechanism such as the Information Quality Incentive (IQI). Our reasoning is explained further in OVQ33.

112. The Customer Value Proposition (CVP) assessment and Confidence-dependent Interval Rate (CDIR) elements of the RIIO-2 information and efficiency incentives did not meet these objectives and weakened the incentive to reveal efficient cost information. CVPs resulted in substantial bespoke projects with questionable customer value being taken ahead, and Ofgem's attempt to deem projects as information revealing or not through the CDIR resulted in a lack of penalty for submitting a plan that was not adequately challenging on costs; neither incentivised the submission of a lean plan. The discretionary assessment of bespoke projects further dilutes the incentive to find cost efficiencies through the period. Maintaining a similar architecture at RIIO-3 would not be in the interest of customers. This is explained further in our following responses OVQ30-31.

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

113. We agree that simplification of the minimum requirements would aid consistent plan submissions.

114. We also agree Ofgem should place more weight on the completeness assessment. It is more effective (and fairer) to impose a penalty where the assessment criteria are set out clearly at the start of the price control, as opposed to imposing a penalty for a subjective judgement regarding the quality of the information.

115. Where Ofgem does include quality requirements, it must set out a clear and definitive definition of quality.

116. Through its SSMC cross sector working groups, Ofgem has indicated that it proposes a move to Excel-based EJPs for Portfolio assets, undermining the NARM framework which is designed to facilitate proportionate reporting. It has also suggested that there will be minimum level requirements but more freedom on supporting information, which risks creating more work without providing more insight. This will open the door for a diverse range of submissions and lead to a data overload, going against the purpose of NARMs and straying into the world of micro-management.

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

117. The high and low confidence breakdown of costs should be dropped as this distorts incentives across cost pots and does not address information asymmetry.

118. Ofgem's attempt to deem projects as information revealing or not at RIIO-2 was not additive to the regulatory framework. The result was a weak incentive where companies were arbitrarily given a lower incentive rate.

119. Ofgem seems to think that this high and low confidence breakdown of costs gave the Business Plan Incentive (BPI) a direct link to the quality of the information and evidence given by network companies, and therefore directly addressed information asymmetry. This is not true. A lower incentive rate for submitting 'non-benchmarkable' costs does not provide a coherent and

incentive compatible framework to encourage companies to only submit well justified activities with challenging cost forecasts.

120. The IQI gave this; a transparent reward or penalty dependent on the relative efficiency of company proposed total cost per customer, that then gave a clear and coherent link to the efficiency incentive.

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

121. The CVP assessment was not transparent at RIIO-2 and should be removed to reduce the focus on discretionary assessment by Ofgem of what constitutes a good plan, as well as reducing the burden on both Ofgem and energy networks.

122. This quality dimension of the information incentive dilutes the cost element. The incentive will be stronger without this CVP element as the focus can be on cost information as opposed to subjective quality assessments that could result in substantial bespoke projects with questionable customer value being taken ahead. These subjective assessments also result in significant incentives for companies to deploy resources (and incur costs) in creating extensive justification, which in turn requires Ofgem to do the same in its assessment. This raises the overall cost to network users of the administration of the regulatory arrangements and should be avoided.

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

123. The ±2% cap on the incentive is sensible and should be maintained at a minimum. Ofgem should consider the incentive strength of the price control package as a whole.

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

124. We would support a move back to the IQI. This is a transparent quantitative incentive that is woven into the price control setting to put the focus on incentivising the submission of challenging plans that reveal the efficient cost of delivery across the industry, while recognising the degree of uncertainty that Ofgem (and the companies) work under.

125. The IQI's strength comes from how it harnesses the interaction between three elements, which come together to ensure that companies are better off submitting only necessary costs where the cost of delivery has been genuinely challenged. These three elements are:

   a. The cost assessment evaluation,

   b. The incentive rate, and

   c. The associated reward or penalty (called the additional income element in Ofgem's earlier iterations of the IQI, which was subsequently blended into the "interpolation with submitted costs" element in later iterations of Ofgem's IQI).

126. These elements act together to ensure that if a company submits a higher cost of delivery than it needs, it will be worse off than had it not done so. The overall effect must be carefully calibrated to ensure this "incentive compatibility" and therefore that companies are encouraged to submit

genuinely challenging plans, i.e. the lowest cost of delivery, while meeting (or potentially exceeding) all the output requirements Ofgem has set. The submission of challenging plans can then also help reveal other companies relative inefficiencies.

127. Ofgem should make use of this financial incentive to help promote the provision of information that will reveal the true efficiency benchmark. In doing so, Ofgem should apply penalties and rewards such that they rise gradually to cover the efficiency spectrum. This will incentivise companies to think hard about where to locate their plans and discourage the submission of plans where costs and outputs have not been adequately balanced.

128. Ofgem's previous iterations of the IQI have been relatively finely balanced, meaning that the rewards and penalties were not large unless a company submitted costs that were substantially different from a true challenging level.

129. They were set in a way that would maintain "incentive compatibility" in a scenario where Ofgem's assessment of necessary costs was independent of the company's submission. This is more likely to be the case in sectors with large numbers of companies, and benchmarked costs, but is less likely for sectors with few comparators.

130. We therefore agree that Ofgem should sharpen the incentive beyond the traditional IQI mechanics to increase the scope for rewards and penalties. At RIIO-1, the inclusion of a potential 2.5% of costs additional reward and fast tracking helped achieve this; but Ofgem could also:

   a. revise the reward and penalty schedule of the IQI to "sharpen" the incentive; and

   b. Recognise the differences between the sectors in terms of the extent to which individual companies can influence Ofgem's view of their efficient costs, considering the sharpest incentives in sectors where this is most likely.

131. Ofgem should not consider Ofwat's weak Quality and Ambition Assessment (QAA). This arbitrary subjective assessment would not incentivise companies to submit lean plans as the scope for rewards would be opaque.

132. We also think Ofgem should not use qualitative incentives to encourage companies to submit ambitious output proposals. Instead a more effective approach is for:

   a. Ofgem to identify and set the output targets at early stages of the price review process (drawing on information from companies where appropriate).

   b. Allow companies to identify a challenging cost forecast for delivering these outputs, with rewards and penalties (and the sharing factor) based on Ofgem's assessment of those costs, through the IQI.

133. It is also possible for Ofgem to take into account outputs within this framework where they can be objectively financially valued; for example if a company proposed as part of its plan to adopt a tougher target where a financial output incentive was in place (e.g. delivery of fewer power cuts), Ofgem could value the adjustment to the target and incorporate this within its cost

assessment. Indeed, there is precedent for this from RIIO-ED1.[3] The important point is identifying an objective, robust way of financially valuing the output; subjective assessments should not be contemplated (for the reasons set out above, and because the lack of an objective financial valuation itself represents a red flag in terms of potential value to network users).

134. Beyond this, network operator outputs should be prescribed by law and the licence; these are the key outputs that Ofgem should seek the true cost of through the IQI. Ofgem has tools at its disposal already to enhance outputs beyond what is prescribed by law, for example customer service incentives, innovation funding, and various other in period incentives. We would encourage Ofgem to give careful consideration as to what additional ambitious outputs are left that give customer value.

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?

135. Ofgem should not fix the sharing rates at the RIIO-2 levels. This would be a poor policy decision, as Ofgem would be choosing not to make use of the efficiency incentives full potential. Alongside incentivising companies to find efficiencies throughout the period once the deal has been set, the efficiency incentive, if linked to the information incentive, can further strengthen the incentive to submit challenging plans. Ofgem should harness this and use the efficiency incentive to its full capability.

136. Ofgem should not use the CDIR approach. This should be dropped for the reasons set out in our response to OVQ30. In sectors where the majority of the cost base is benchmarkable it does not give strong enough incentives.

137. The strongest policy decision and the best outcome for customers would be to link the efficiency incentive to the information incentive by setting sharing factors based on the efficiency of company costs using a transparent formula – i.e. an IQI.

138. In using the IQI to set the sharing factors, we would encourage Ofgem to consider sharpening these incentive rates from RIIO-1. Ofgem can use the IQI ‘slopes’ to cater to the relative competition within each sector, to ensure the incentive to submit a challenging plan and find efficiencies through the period is strong enough.

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?

139. The current scope of the Net Zero reopener in these sectors is already too broad. It should not be blank cheque for any funding that can be linked to Net Zero.

[3] The additional financial value of tougher interruptions targets for WPD was incorporated into Ofgem’s fast track cost assessment at ED1. Although this this represented an irregularity within the process set out at ED1, since it represented a variation to WPD’s submitted plan (rather than being part of the submitted plan itself), it illustrated the principle with regard to incorporating output value in an overall value assessment.

140. Ofgem should limit the scope of this reopener to a change in efficient expenditure necessary due to a change in legislation or policy. Ofgem can do this by ringfencing the trigger to major shifts in government policy or legislation, such as a change in the 2050 Net Zero target date.

141. This will limit the scale of the submissions to a manageable amount, and keep the additional funding focused to contextual changes that have occurred since RIIO-3 planning and determinations.

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?

142. The use of use-it-or-lose-it (UIOLI) funding can be beneficial here, as it ensures customers receive the benefits of the approved projects and ensures energy networks are not a blocker to Net Zero.

143. However, UIOLI funding does not incentivise efficiency – so this funding mechanism should be ring-fenced to projects that are absolutely critical to enabling Net Zero.

144. We support Ofgem's proposal to tighten the scope of this mechanism.

   a. If government decisions give certainty around hydrogen ahead of the determinations, Ofgem should construct the scope accordingly.

   b. There will be some investments that can be funded elsewhere through the ex-ante baseline, despite aiding the move to Net Zero. These should be kept within ex-ante allowances where possible to incentivise companies to find cost efficiencies in delivery and allow companies to adjust plans to the most cost efficient solution.

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?

145. While we cannot comment on the type of projects that would be within the scope of this mechanism, as that is specific to gas distribution and gas transmission, Ofgem should consider whether this mechanism is required at all.

146. We think it could be dealt with simply by increasing the cap on the UIOLI fund, as this covers the same scope at different magnitudes.

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

147. There were too many uncertainty mechanisms at RIIO-2; this proliferation, and Ofgem's tendency to delay decisions that relate to critical investment, is not in the interests of customers. Ofgem's intention to reduce the number of reopeners at RIIO-3 is positive, but it must not to expect that simply reducing the number of reopeners, whilst maintaining the current scope for funding, will reduce the resource burden. This would also leave the same level of uncertainty in the price control – Ofgem must reduce this to restore investor confidence, be more decisive at the time of the price control settlement and stand behind its deal.

148. Also, a blend of these reopeners with the current scope would blend means driven (e.g. the why) with delivery driven (e.g. the what). This would allow reopener submissions that muddy the line between truly additional costs associated with a change in the assumptions used to set baseline allowances and new projects companies would simply like to do.

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?

149. We agree that this mechanism may become more useful in RIIO-3 as the role of whole systems strategic planning increases.

150. However, Ofgem should not incentivise its use. Companies will use it where it is necessary, likely once the FSO 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?

151. Ofgem should retain the standalone physical security mechanism, with a targeted scope and trigger.

152. As explained in our response to OVQ38, too broad a scope will allow submissions that include both changes to the “what” as well as the “why”, and thus damage efficiency incentives within the price control period to avoid excessive work.

153. For example, it is not necessary to explicitly bring within scope the enhancement of physical or personnel security at Critical National Infrastructure (CNI) sites. The only trigger required is a change to the CNI guidance, which in turn may require enhancement of the site (and hence make allowance for necessary costs which could not have been forecast at this price review, since they were caused by changes to the guidance). The mechanism should only allow for submissions regarding the additional cost required to meet the enhanced level.

OVQ41. Do you agree with our proposed approach to introduce a resilience reopener?

154. If Ofgem is to bundle various RIIO-2 reopeners into this broad reopener, it must keep the licence criteria very clear on the triggers for each element. Simply combining the current scopes will not resolve the resource issue. Ofgem should consider whether separate mechanisms would allow for greater transparency in submissions and hold itself accountable to only introduce scope for additional funding where there is a clear and justified trigger. Separate mechanisms also allows staggered submission and evaluation windows, which in turn can also help Ofgem to manage the resource burden.

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?

155. We support the retention of the opex escalator; additional funding for indirect costs is essential to support a large increase in capital expenditure.

156. We agree that it should not lead to double funding and should only fund the incremental indirects costs associated with the uplift in capital expenditure.

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

157. Additional funding requests are already subject to Data Assurance Guidance (DAG) forms. We would question whether any further governance requirements are needed. Any new requirements must be clear and proportionate.

158. Clawback of double-counted funding through an uncertainty mechanism should not be needed. This can be avoided through the use of clear licence conditions with limited scope and targeted triggers that only provide funding for incremental requirements. If Ofgem does introduce conditions that require clawback of double-counted funding it risks seriously undermining its incentives for efficiencies to be identified within the price control period within both baseline and incremental funding, whenever a licensee triggers an uncertainty mechanism.

Cost of Service (RPEs and OE)

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?

Real price effects

159. We do not support the indexation of real price effects. These allowances should be funded ex-ante to reduce the risk companies face from economic shocks. Companies would still have to manage the risk of outturn real price effects being higher than allowed for and find efficiencies, as the use of imperfect indices creates yet another dimension of risk around the variation in those indices to the real price effects companies actually face.

160. If Ofgem is to continue to index real price effects, it should consider applying mean adjustments to ensure companies are compensated for short-term movements in unit costs. Sometimes the indices used, despite being correlated to company unit costs, have long run growth rates that are systematically below company unit costs and therefore without mean adjustments risk systematically underfunding actual unit cost growth. Mean adjustments would correct for this risk given that indexation does not allow companies to manage the risk internally.

161. We have several further recommendations for the evolution of the RIIO-2 methodology for RIIO-3, to ensure that companies are fairly compensated for the real price effects they face. They are as follows.

162. Firstly, Ofgem should fund real price effect allowances across the total cost base, where there is evidence of a real price effect, regardless of the materiality of each cost category. At RIIO-2, Ofgem used a materiality threshold of 5% of the totex of a notional efficient company for a cost category to receive a real price effect allowance. This materiality threshold should be dropped. In the extreme, if the cost base was broken into small enough pieces, no cost category would pass the materiality hurdle, even though real price effects in the aggregate could be very material.

163. There is the risk that in dismissing cost categories of smaller magnitude, Ofgem forgoes funding what could become material real price effects in the period. A mechanism that covers the total cost base would ensure that it covers all aspects where market volatility can creep in.

164. If Ofgem were to maintain the materiality threshold for the application of a real price effect to a cost category, we would encourage Ofgem to consider cases where there is evidence of real price effects for smaller categories when they are combined.
    a. For example, in RIIO-2 Ofgem classed Plant & Equipment and Transport as separate cost categories.
    b. Separately they can be of low materiality, however there are price indices that combine plant and transport and evidence a real price effect for the categories together.
    c. If these categories are low in materiality separately, Ofgem should examine whether there is evidence of a real price effect for these categories combined, for example with the use of an index such as "BCIS PAFI plant and road vehicles (90/2)".
165. Secondly, Ofgem should also be open to using a broader set of indices, rather than only relying on regulatory precedent. This would reduce the risk of exposing network companies to an index and cost mismatch. Ofgem should continue to monitor the evidence as to which indices are better correlated to company costs in each sector, and be open to funding cost categories where there is not precedent for real price effects allowance.
    a. 'Other' costs did not receive an index at RIIO-2 because as there is no precedent of a price index being used here to determine the gap to inflation.
166. Thirdly, Ofgem should consider whether it can make use of the efficient notional cost structure associated with the allowances it gives in setting real price effects. At RIIO-2, Ofgem used the notional cost structure as per submitted business plans, which did not reflect the disallowances made. Ideally, the totex real price effect allowance should reflect efficient cost structures.
167. Finally, Ofgem should consider whether to forecast the price growth of the indices using the long run price growth of the index or using the long run real price effect given the economic forecast at the time of determinations; the latter method tending to be a better forecast in times of high inflation where it is likely that input price growth will not be in line with the long run average.

Ongoing efficiency

168. We support the use of Total Factor Productivity estimates from EU KLEMs data to estimate ongoing efficiency.
169. We would encourage Ofgem to listen to the evidence, which is increasingly showing that an ongoing efficiency assumption is around 0.5% per annum. It must not cherry pick an ongoing assumption at the higher end of its estimated range.

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

170. In our view, a successful reopener application based on forecast data should be given an ex-ante real price effects allowance upfront. As the funding request will be made throughout the period for costs in the near term, at most four years away, forecast real price effects at the time of Ofgem's assessment of the additional costs will be accurate enough. This will also increase simplicity.

171. Also, it is fair to impose an ongoing efficiency assumption on additional funding for forecast spend, if the policy decision at final determination to apply the ongoing efficiency challenge to that type of cost.

Cyber security

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

172. On cyber resilience information technology (IT) and operational technology (OT) plans, we support the proposal to combine the guidance documents and agree that this will assist in simplifying the navigation of the guidance documents.

173. We suggest the need for two plans should be reviewed, with consideration for combined submission. With the expansion of Network and Infrastructure Systems (NIS) scope we see little value in an IT/OT split that is often subjective and introduces complexity into the plan production and review process.

174. We support the submission of cyber costs through the Business Plan Data Templates (BPDTs). However we do not think there is a sufficient level of similarity between company approaches to effectively allow for meaningful benchmarking. There is a risk that comparative benchmarking would benchmark away cyber plans that are required to get companies who are behind up the curve. Ofgem must approach assessment of cyber costs with care so that companies have appropriate allowances set.

175. We agree that the funding for IT spend should be within the baseline totex to incentivise companies to find cost efficiencies. It seems appropriate for OT spend to be funded through a UIOLI allowance.

176. We support Ofgem's proposal to have a higher bar for the use of PCDs, which will reduce the regulatory burden. We agree with the proposal to retain the mid period reopener, and that the authority should retain the ability to trigger reopeners in response to changes in threat levels or government policy or guidance.

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?

177. We support Ofgem's proposal to continue to facilitate network companies ambition to innovate through the retention of Network Innovation Allowance (NIA) funding. Its flexibility has been helpful in allowing projects that see promising results to take off.

178. However, decarbonisation has changed the market's risk profile for innovation. In this new context, appetite for innovation is less risk averse as the scope for gains through innovation and the opportunity cost of not seeking innovation is larger.

179. The Department of Energy Security and Net Zero (DESNZ) estimates that £23 billion worth of low-carbon investment will be required through the late 2020s and 2030s to achieve Net Zero4. This will only be significantly reduced by either a substantial shift in customer behaviour, or innovation. Network companies must not be the blocker to affordable decarbonisation. Ofgem must increase the size of the upfront innovation funding and lower its aversion to flexing allowances upwards to allow networks to benefit from innovative wins that would reduce the cost of Net Zero for consumers.

180. The larger the upfront funding for innovation, the greater scope for gains through first-mover advantage and therefore boosting the network companies incentive to innovate. The benefits of these innovations will ultimately bring about the lowest cost for customers in the long run.

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?

181. Ofgem is right to retain a larger-scale competitive funding pot to support trial roll-out of new technologies.

182. The successes of large trials supported by predecessor funds such as the Network Innovation Competition (NIC), and the Low Carbon Network Fund (LCNF) before it, are evident. These now form the core of Distribution System Operator (DSO) and flexibility technologies being applied to networks, demonstrating the value of this type and scale of funding.

183. Innovations will need to be tested at scale in the field if it is to have an impact large enough to bring down the cost of decarbonisation. This requires major trials at an increased scope and size across the industry; the current Strategic Innovation Fund (SIF), with both its phased and direct entry options, will support this. Customers will benefit from Ofgem's enabling of competition here; it will promote innovation beyond network companies themselves and further reduce costs to customers in the long term.

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?

184. Joined-up thinking and strategic alignment across sectors is to be welcomed where it benefits customers.

185. Our innovation projects and development strategies are built on public and customer consultation. This ensures a considerable level of strategic alignment is already built into our innovation activities and the projects we choose to pursue.

186. Innovation funding for whole systems solutions shouldn't displace funding for single network company innovation projects – the funding pot should extend further where required to meet public sector initiatives.

[4] HM Government, Mobilising green investment: 2023 green finance strategy, March 2023, p.18.

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?

187. As explained in our response to OVQ47, the overall level of funding must be increased to deliver at pace the ambitious transformation required over the next decades.

188. The overall level of funding for innovation is meagre, typically in the range 0.5 to 0.6% of turnover for NIA funding, with SIF funding accounting for a further 1%. This is considerably lower than the UK Government target of 2.4% for the country as a whole and current level of 2.7%5.

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

189. The level of third-party participation in innovation stimulus funding is already substantial, with opportunities plentiful for third parties to present good quality innovation project ideas.

    a. All licensees using NIA funding are limited to 25% of spending on internal costs such as project development and support, dissemination, and development of outcomes for business-as-usual adoption. The remaining 75% of this funding is spent with third parties.

    b. Alongside other distribution network operators, we set-up and continue to support the Energy Innovation Centre (EIC). The specific purpose of the EIC is to support small and medium enterprises in their interaction with licensed operators, both gas and electricity, and assist them in the pitching and development of innovative ideas into viable projects. These are then funded using current innovation stimulus mechanisms.

190. As per the competitive market condition set up by Ofgem, third party proposals that are highly ranked are taken forward, whereas others are not. This is rightly a high-bar for project take-up, and therefore investment of customers' money into the most promising projects. This has led to a diverse range of ideas being taken forward and adopted by industry.

191. If Ofgem were to increase the size of the funding pot, this would naturally extend the funding to more projects from both network companies and third parties. An increase in third party funding should not displace network funding for the sake of balancing numbers; the most promising projects within the funding scope should be taken forwards, regardless of the proposer.

192. Increased innovation to network companies as well as third parties will no doubt aid the search for a more affordable path to Net Zero. We would suggest that any increase in funding to third parties is given such that unregulated entities, like licensed entities, are compelled to be open in execution of projects and in disseminating outcomes. Licensed entities have an inbuilt need to ensure that project outcomes are efficient, non-burdensome, represent value for the customer and take account of all aspects of the regulatory and operational environment. Further, licensed entities tend not to be looking to extract profit from innovation trials, but instead reap the long run benefits.

[5] Research and development spending, Research Briefing, Published 11 September 2023, House of Commons Library.

193. Consideration would also need to be given to mechanisms for clawback of third party funding not properly spent and to find mechanisms for compensating customers for the investment made in the case of successful outcomes with commercial value.

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

194. There are multiple accelerators already in play, specifically for the energy sector and also for Digital and other areas of interest for the industry. The Catapults are well embedded within the current innovation landscape and within individual projects funded through both SIF and NIA.

195. Any further accelerators to support early-stage innovators are of course welcome to promote innovation and increase the opportunity for big wins that can aid enabling Net Zero. But these must not displace the small innovation funds available to network companies – Ofgem must increase the size of the pot and be mindful of how it should regulate the unregulated entities.

196. Ofgem would need to prove tangible customer benefit of the introduction of further accelerators, with evidence that their specific remit would be that is not currently fulfilled, or could be fulfilled, by incumbents.

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?

197. We would welcome clarity from Ofgem as to how this would not double count the funding for third parties as explained in our response to OVQ51.

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?

198. Innovation is being rolled out at a greater rate than seen in previous decades. Roll-out of investment tends to span across multiple price control periods, as our aim is to achieve benefits in the long term.

199. An example of this is the Foresight project, an innovative fault prediction technology based on a power electronics platform originally developed by UKPN and further developed and proved by Northern Powergrid during RIIO-ED1. We were unable to secure funding in the RIIO-ED2 settlement to roll this out, delaying implementation until RIIO-ED3.

200. Innovation projects should be funded such that they are able to span multiple price controls.

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?

201. Future Regulation Sandbox (FRS) trials could be funded through existing innovation funding pots where the eligibility criteria is met for simplicity. There should not be an additional reopener for these costs; these trials should only take place where they have evidenced high customer benefit against competition innovation projects.

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

202. The FRS trials should be subject to the same competitive arrangements as other innovation projects. Ofgem should let these market conditions give rise to the projects that are the most promising, within the eligibility criteria.

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?

203. Please see our response to OVQ54, which gives some examples of innovation projects that are being rolled out.

204. If Ofgem would like to increase the number of innovation funded projects that are rolled out, it should significantly increase the scope for funding. This is an obvious way to open up the door to innovations in our view.

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

205. A mechanism that allows network operators to retain a proportion of the gains from the fast roll-out of innovation across price control periods would alleviate some of these issues and accelerate implementation.

206. Any such mechanism must be easy to use and implement, with a presumption attached to innovation trial outcomes. For example, any gains for the next two price control periods could be retained. This would allow sufficient time for implementation and exploitation before the economic advantage is reverted to the customer. Sharing factors could be applied and a system to register could be deployed, perhaps akin to the self-certified NIA.

207. The previous Innovation Roll-out Mechanism (IRM) was effectively a reopener and administratively complex and burdensome. As a consequence it was not well used.

Data and digitalisation

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

208. The high level timelines seem reasonable. However, we will validate this as part of the consultation process regarding the Data Sharing Infrastructure (DSI) as we expect this to heavily influence the infrastructure referenced.

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?

209. There are opportunities in improving efficiency relating to data sharing; the use of open data portals and application programming interfaces are good examples of this. Ofgem should be mindful that efficiencies could be hindered depending on the data standards and configurations requested. Also, Ofgem should only request data where it is required by necessity to avoid data overload and allow for the data to be submitted efficiently at to a high standard of quality.

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

210. No comment at this time. We will respond through Ofgem's DSI consultation.

Finance Annex

Allowed return on debt

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

211. At a time when attracting significant capital investment in the UK's electricity networks is critical to meeting our Net Zero commitments, it is essential for Ofgem to fully recognise the significance of the UK Regulators Network (UKRN) guidance statement that regulators should take into account the "value of predictability and stability when attracting finance that may span several price control periods".

212. This statement was applied by the UKRN specifically to changes to the inflation assumption used to deflate nominal yields – and we support it in that context – with the UKRN describing early signalling and an evidence-based rationale as necessary for any changes in this area.

213. However the UKRN guidance does not contemplate proposals to change major cornerstones of the regulatory financial framework, and therefore it falls well short of defining a proportionate safeguard in the case of major proposed changes such as Ofgem's options 1 and 2 for the cost of debt.

214. Here we think that a proportionate safeguard is to start from a presumption that unilateral changes will only be applied to new investments, consistent with the precedent from Ofgem's approach on adjustments to regulatory depreciation under RIIO, and even then only where evidence supports a strong case for change. This is the only way to a transition that deals fairly with the fact all companies have chosen their existing financing arrangements in light of the same long-standing regulatory approach to this parameter.

215. Beyond this apparent failure of the UKRN's recommendation 8 to contemplate changes to major financial cornerstones of the type now suggested by Ofgem, we generally agree with the approach the guidance sets out.

216. Our only other comment is that we do not believe it would always be appropriate to exclude derivatives when assessing the actual cost of debt; instead the decision should be taken on a case-by-case basis, particularly where instruments have been put in place contemporaneously and back-to-back with a standard debt instrument. Ofgem already seems to have recognised this, however, and departed from the UKRN wording in the case of foreign exchange rate swaps, and it is possible that there may be other cases where it is sensible to include specific derivatives.

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

217. Real cost of debt allowances and inflation indexation are cornerstones of the regulatory regime that have a tried and tested, proven track record of attracting equity and debt capital to the sector. We support Ofgem retaining them (i.e., a version of option 3).

a. Stability has a value - Ofgem has not cleared the hurdle that shows the current arrangements are a detriment to customers over the long term. The consultation only provides high-level details on possible future approaches, altering such a key aspect of the price control should not be taken lightly and needs to be considered in the context of the price control as a whole. Given the effectiveness of existing arrangements around inflation and Ofgem's approach to allowing for the cost of debt, there is much to lose if ill-considered changes are made.

b. A review of Ofgem's long-run inflation assumption, under option 3, does not rule out the current approach. Ofgem has not been clear what is wrong with the CPIH inflation forecast provided by Office for Budget Responsibility (OBR) that is currently used. The OBR was established by the UK Government to provide independent economic forecasts. In any case its long-run inflation assumption must be fit-for-purpose, credible and independent - inflation breakevens from index linked gilts are not. Instead, a more credible approach to deriving the inflation assumption must be found before a departure from the RIIO-2 approach is seriously entertained.

218. Beyond the above headline, our key points in response to this question are as follows.

a. As a matter of principle we oppose unilateral and unjustified changes to inflation linkage of past investments included in RAV, as doing so would unduly damage investor confidence.

b. For future RAV additions in RIIO-3 and beyond, options 1 and 2 would introduce untested hybrid complexity that may reduce investor appetite for the sector…

c. …and we think Ofgem's proposal to maintain its debt indexation methodology will deliver the best outcome (i.e. option 3). There are significant advantages to retaining a mechanism that has worked so well in the past, provided any adjustments are well-balanced, justified and retain credibility with investors.

d. To the extent option 1 or 2 are considered, e.g. for new investments, option 1 is a much stronger proposition.

e. We do however support Ofgem's proposals to continue fine tuning its approach to calibrating debt indexation.

219. In the rest of this question response we set out our fuller views in relation to each of the above bullet points, a) to e).

a) As a matter of principle, we oppose unilateral and unjustified changes to the inflation linkage of past investments included in RAV, as doing so would unduly damage investor confidence.

220. The inflation indexation of the entire RAV has been a cornerstone of energy network regulation in Great Britain since the regulatory framework was established in the 1990s, delivering strong outcomes for customers over a 30-year period.

221. An unjustified change by Ofgem to such a longstanding feature of the regulatory system would go against long-held and reasonable expectations of investors that the approach to inflation indexation of investments they were making would be maintained.

222. Accordingly, Ofgem should respect the established approach to RAV indexation for historical investments. Any prospective changes should apply only to new RAV additions, such that investments made under the previous arrangements gradually run-off.

223. If any move is made away from the current approach, we believe that a shorter transitional period would, in our view, be insufficient for such a fundamental change to the regulatory system (as per our response to FQ3).

b) For future RAV additions in RIIO-3 and beyond, options 1 and 2 would introduce untested hybrid complexity that may reduce investor appetite for the sector…

224. Both of options 1 and 2 would introduce a hybrid system where debt and equity RAV receive significantly different approaches to financial remuneration.

225. A hybrid approach such as these options would leave GB energy networks with a complex, unusual and untested financial approach that is extremely rare globally – a regime that is part real, part nominal.

226. This hybrid complexity could adversely affect the sector's attractiveness to investors.

227. The full indexation of RAV and the associated freedom for investors to choose how to finance their businesses creates an overall structure that has proven attractive to investors – and that has been very beneficial to customers.

228. A change of this nature risks reducing the energy sector's attractiveness relative to assets in other regulated sectors that retain inflation indexation of the entire RAV (both in GB and globally) at a time when there is strong global competition for capital in energy networks.

c) For future RAV additions in RIIO-3 and beyond, we remain strongly of the view that Ofgem's proposal to maintain its debt indexation methodology will deliver the best outcome (i.e., a version of option 3).

229. Ofgem's explicit rationale for changing its approach is to remove the so-called "leverage effect". This effect only has a detrimental effect on consumers if one believes that over an enduring period Ofgem's long-run inflation assumption has been systematically, and asymmetrically, incorrect in a predictable direction.

230. Stability has a value - Ofgem has not cleared the hurdle that shows the current arrangements are a detriment to customers over the long term. The consultation only provides high-level details on possible future approaches, altering such a key aspect of the price control should not be taken lightly and needs to be considered in the context of the price control as a whole. Given the effectiveness of existing arrangements around inflation and Ofgem's approach to allowing for the cost of debt, there is much to lose if ill-considered changes are made.

231. A review of Ofgem's long-run inflation assumption, under option 3, does not rule out the current approach. In any case its long-run inflation assumption must be fit-for-purpose, credible and independent - inflation breakevens from index linked gilts are not. Instead, a more credible approach to deriving the inflation assumption must be found before a departure from the RIIO-2 approach is seriously entertained.

232. Ofgem needs to prove there is clear customer benefit before it moves away from its current policy position. The UKRN's guidance is highly relevant, since it states in this context that "using medium term forecasts or a long-term assumption (e.g. the Bank of England's inflation target) to deflate are both acceptable approaches."

233. The UKRN's guidance does recognise that it is important to carefully consider the inflation assumption required to deflate nominal debt yields – but as well as saying Ofgem's RIIO-2 approach is acceptable, it also stresses that "early signalling and an evidence based-rationale will be necessary to manage the effects of a change in this area."

234. The consultation mentions using inflation breakevens from index linked gilts as one potential alternative approach to deflating nominal cost of debt data. However these breakevens will incorporate an inflation risk premium that means they cannot provide direct evidence on expected inflation; moreover there is significant potential for gilts specifically to be distorted by gilt market-specific factors, such as the convenience premium on gilts, or potentially pension fund regulations driving purchases of particular types of government debt. At present the figures they give for inflation are so far above the expert consensus around longer term inflation that this must cast doubt on the credibility of the breakeven data for this purpose. Instead a more credible approach to deriving the inflation assumption must be found before a departure from the RIIO-2 approach is seriously entertained.

d) To the extent option 1 or 2 are considered, e.g. for new investments, option 1 is a much stronger proposition.

235. Although we oppose what we regard as a unilateral retrospective change to the funding of past investments, we recognise that Ofgem could legitimately implement one of its alternative options for new RAV additions with adequate notice and an appropriate transition.

236. Of the two options, option 1 is the significantly better.

   a. Under option 1, Ofgem would marry the existing GB system of inflation for equity investments with the approach seen on debt in many other jurisdictions that apply a nominal yield.

      i. The overall hybrid effect would be an untested regulatory system; however

      ii. the individual elements (debt and equity) would at least be familiar to investors.

   b. Option 1 has the spin-off benefit of accelerating cashflows in a financeability framework that has slowed them down excessively, but at the cost of creating a more complex, hybrid regime.

      i. The cash flow acceleration that would occur as a result of this change does not resolve the fundamental customer bill and network financeability issues caused by Ofgem's current asset lives policy.

      ii. With or without a change to the cost of debt mechanism, Ofgem must address this issue by tackling the root cause of this problem – its overly long regulatory depreciation policy in the context of electricity distribution. Adjusting this depreciation life is the appropriate policy to address issues relating to allocating costs fairly between current and future customers and network company financeability.

c. Under option 2, Ofgem would retain the existing GB system of inflation for equity investments but adopt an approach on debt that we do not believe is seen in any jurisdiction.

   i. The existing GB approach on debt has the disadvantage of significantly slowing cashflows (relative to typical debt financing) – however it carries offsetting advantages through inflation protection.

   ii. The approach suggested in option 2 would retain the disadvantage of slowed cashflows, through an essentially arbitrary deduction from debt interest being fed into RAV growth, without conferring any offsetting advantage to investors.

   iii. This approach would, to our knowledge, be unique for a network investment regime, and would make GB energy networks a less attractive proposition for investment over the longer term.

   iv. This 'worst of both worlds' approach is likely to raise the overall cost of financing investments in GB energy networks and therefore be detrimental to current and future energy consumers.

237. The timing of the potential detriment that option 2 would bring about is particularly poor, undermining investor confidence at a time when very large investment programmes need to be financed and delivered. For this reason, if Ofgem adopts either option it should chose option 1 ahead of option 2.

e) We do however support Ofgem's proposals to continue fine tuning its approach to calibrating debt indexation

238. As was the case at RIIO-2, we support Ofgem's proposals to continue fine-tuning the approach to sector-wide benchmarking and indexation of debt costs.

a. Weighting historical years by sector RAV additions, with allowances for re-financing, could be considered if they would materially improve calibration. However this must not undermine the general principle that Ofgem is attempting to establish a realistic high-level benchmark of the sector's actual expected cost of debt.

   i. Any refinancing assumptions should have reference to the historical debt issuances that are still in issue for a sector, rather than solely being an arbitrary tenor assumption.

   ii. Using an average tenor of 15 years, for example, could conceal an expectation of some debt issuances being potentially substantially older than this.

b. We note that in some circumstances it may be appropriate to include inter-company loans in the calculation, on a case-by-case basis, for example if a captive finance company loans the proceeds of debt issuance to its parent network company.

239. We have commented separately, earlier in this question response, on Ofgem's proposal to review the long term inflation assumption as part of its current debt indexation methodology.

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

240. As set out in response to FQ2, we oppose the major unilateral methodology changes proposed under option 1 and option 2, for past investments included in RAV.

241. As this change would constitute a fundamental shift in the regime, we consider that the structures under which past investments included in RAV were accumulated should be honoured as the lifetime default treatment of those RAV additions.

    a. Therefore, the default transitional approach would be to allow investments under the prior system to gradually run-off, and be replaced by investments under the new system.

    b. Any new system should therefore only apply by default to future RAV additions in RIIO-3 and beyond.

242. Shorter transitional periods of the type so far suggested by Ofgem would, in our view, be insufficient for such a fundamental change to the regulatory system.

243. Beyond this, we have the following additional views on implementation methodology:

    a. Company specific approaches should not be adopted, in line with Ofgem's longstanding position and the guidance recently issued by UKRN.

    b. Ofgem is conflating two distinct policy decisions when reviewing the assumption for the notional capital structure.

244. We expand on these two views in the rest of this question response.

a) Company specific approaches should be ruled out, in line with Ofgem's longstanding position and the guidance recently issued by UKRN.

245. There are at least three strong reasons that Ofgem should rule out company specific approaches to an index linked debt assumption:

    a. Firstly, all companies have taken decisions on financing in light of the same system; and companies with little or no index linked debt have an equally reasonable expectation for consistency over time in their treatment.

    b. Secondly, Ofgem has a longstanding position of not adopting company specific approaches to debt which the UKRN guidance has recently cemented, which would be undermined.

    c. Thirdly, higher index linked debt assumptions for some companies would exacerbate the practical implementation considerations for all companies.

246. The first point above recognises that each company, faced with the current regulatory system, has taken decisions on its financing that have created an investment that suited their investors' own preferences.

    a. Some investors have chosen to issue relatively large amounts of index linked debt, and in doing so they have obtained short term cashflow benefits (while giving up the benefits of inflation on a portion of the RAV equal to the indexed linked debt issuance and adopting a different profile of inflation risk).

    b. Other investors have chosen to issue fixed nominal debt, and in doing so have chosen to absorb the cashflow disadvantages, specifically in order to retain the benefits of inflation protection on the portion of RAV associated with this debt.

247. Ofgem deciding to respect and preserve the choices of one set of investors, while over-writing the choices of a different set of investors, would be perverse and damaging to regulatory consistency and certainty.

248. Turning to the second point, Ofgem has a long-established position of not adopting a company specific cost of debt allowance, which the UKRN guidance has recently cemented.

a. Ofgem has elucidated many reasons for its position, and summarised several of these in its statement at the ED2 final determinations that:

> *"Remunerating individual company actual costs of debt would represent a significant change in the approach adopted by GEMA over at least 20 years across the different sectors we regulate. This could call into question the stability and predictability of the regime, which would have negative consequences for consumers. It would also retrospectively expose the consumer to risks around financing decisions that we consider better sit with shareholders."*[6]

b. The adoption of company-determined indexed linked debt weights would immediately pass individual company decisions on debt structuring through to system users. The UKRN guidance on establishing the cost of debt states that:

> *"The allowance should be based on the notional financial structure, to limit the ability of individual companies to 'pass through' their costs to customers without checking these costs are efficient and reasonable."*

249. Thirdly, there would also be practical implementation complications. For example, if Ofgem uses company specific index linked debt weights it would become necessary to make a company specific deduction from the sector-wide cost of debt for those companies if Ofgem believes the companies have achieved any cost-reductions associated with that indexed linked debt; there would also need to be an offsetting uplift to the sector wide cost of debt for other companies for the same reason.

b) Ofgem is conflating two distinct policy decisions when reviewing the assumption for the notional capital structure.

250. It is appropriate that Ofgem is undertaking a review of the notional assumption on index linked debt used for financeability testing. The financeability testing should have a basis in how companies are financed in practice. If the current 25% assumption is no longer broadly reflective of overall financing arrangements for the sectors then it should be updated, and this warrants a high-level review.

251. For the purposes of setting cost of debt allowances, Ofgem is not required to adopt the same assumption as it uses in its financeability testing duty.

a. This does not mean they cannot be underpinned by the same notional structure, but they do not have to be.

b. This is well evidenced by the current regime where a real cost of capital allowance is implicitly set using a 100% index-linked debt assumption, and then the testing of the

[6] Paragraph 2.114, page 29, finance annex to the RIIO-ED2 determinations

financeability duty is underpinned with an assumption that 75% of debt is fixed and 25% is index-linked.

252. However, setting the proportion of debt cost allowances that are index linked at 0% for the sector would not remove the possibility of a sector's shareholders benefitting from inflation outperformance on debt. This is because:

a. the energy network sectors do have index linked debt in issuance;

b. Ofgem would still need to use a future inflation assumption to "inflate" the cost of this index linked debt in order to calibrate a nominal cost of debt index at a reasonable level for the sector; and

c. Over or under forecasting of this inflation assumption would still flow through into shareholder returns (with a negative rather than positive correlation to actual inflation).

253. This complicated picture gives another reason for Ofgem to adopt option 3, on a properly implemented basis. It also illustrates why Ofgem should not move to a 0% index linked cost of debt model, even if it wishes to remove the possibility of a leverage effect occurring across the sectors as a whole.

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

254. No – we support option 3, maintaining the current approach to indexation (with appropriate calibration).

255. If Ofgem does decide unilaterally to move away from option 3, then we think the least damaging alternative would be option 1. This should be implemented on new investments only to allow for a gradual transition that fully respects the framework under which historical investments were made.

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

256. An allowance for additional borrowing costs and the infrequent issue premium is essential to making full allowance for the cost of debt in any price control settlements that benchmark the cost of debt in a finely calibrated way based on observed debt coupons, - as is the case in Ofgem's approach. It is important therefore that Ofgem maintain these allowances, reviewing them to ensure they remain set at an appropriate level.

257. Beyond this high level point, the ENA has submitted to Ofgem a number of reports on the cost of capital, and this includes the additional allowances related to the cost of borrowing. We refer Ofgem to these reports as supplementary to our response.

Allowed return on equity

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

258. In order to meet its Net Zero objectives, the UK must attract and retain very substantial investment in electricity networks over the coming decades.

259. Seen in this light, the importance of the cost of equity in the RIIO price controls cannot be understated – it is the Ofgem's single most important lever to meet these commitments. So even while we agree with many of the elements the UKRN recommendations, and Ofgem's interpretation of them, we think this granular view risks losing sight of the criticality to Net Zero of the cost of equity being set at an adequate level.

260. It is therefore vital that Ofgem keeps this bigger picture in respect of the electricity networks in direct sight as it considers the individual parameters of its cost of equity assessment, along with the way in which it considers its cross checks.

261. Turning to individual parameters and cross checks, the ENA has provided Ofgem with several expert reports that give relevant detail on individual parameters of the cost of equity as well as cross checks. We therefore refer Ofgem to these and do not attempt here to replicate their detail on the individual parameters.

262. Beyond this we have one other high-level comment in relation to Ofgem's proposed approach to establishing the overall allowed cost of equity. In Paragraph 3.88 of the consultation, Ofgem recognises the CMA's findings in the T2 and GD2 appeals and states it does not propose to reintroduce step 3 (the expected returns adjustment) into its process for assessing allowed returns at RIIO-3. We support this position. However, Ofgem goes on in the same paragraph to suggest that it may reverse this position, saying " if there were any evidence of this [i.e. skew in expected returns e.g. due to incentives], we may need to adjust the allowed return on equity such that expected returns match our best estimate of the cost of equity".

263. It is difficult to be certain that Ofgem intended to say in one sentence that it does not propose to reintroduce a particular process and then say in the next sentence that will still maintain it.

264. The UKRN guidance instead offers an appropriate response which Ofgem should reflect in its position, which is to say that "regulators could aim in the first instance to address any returns asymmetry 'at source' through recalibrating incentives and/or policy commitments in a given policy area, rather than aiming off the allowed return on equity". In other words, if expected asymmetry of outcomes (e.g. on incentives) becomes an issue when Ofgem looks at the price control overall, Ofgem can solve this by going back to the relevant elements (e.g. incentive targets or rates) and recalibrating them.

265. This UKRN suggestion should be adopted as Ofgem's policy should this situation arise. Aiming off on the cost of equity (such as the T2 and GD2 expected returns deduction) is damaging to energy consumers in two respects.

a) It undermines Ofgem's incentive for investment, which is critical the context of Net Zero) and

b) It would be vulnerable to successful appeal, potentially without any changes to other parameters (which may not be appealed and may also not cross the threshold for a CMA determination to revisit them).

266. If Ofgem instead targets its adjustment to the parameters of the settlement that have created any expected outperformance issue, the risk of these damaging outcomes for consumers could be substantially reduced.

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

267. The criticality of investment in electricity networks to facilitate the UK's Net Zero transition, and the resulting substantial investment in these networks that Ofgem must attract and retain over the coming decades, provides the strongest possible imperative for Ofgem to ensure that excessive adherence to the UKRN recommendations does not result in a cost of equity that is too low. The cost of equity is Ofgem's strongest incentive for investment and its importance in the context of Net Zero must not be understated.

268. There are at least two areas where the UKRN recommendations raise potentially substantial issues in respect of encouraging the investment necessary to deliver on Net Zero.

   a) The first is the proposal to derive symmetric ranges for individual parameters and then use the mid-point of the overall cost of equity range.

      i. Although regulatory practice has varied between regulators and over time, there has been repeated recognition that the risks of consumer harm from under-investment in response to setting the cost of equity too low are more substantial than the costs of setting a slightly higher cost of equity.

      ii. The Net Zero imperative now provides a stronger rationale than ever before for ensuring the cost of equity is not set too low, at least in the case of electricity networks.

      iii. Setting a mid-point cost of equity will leave a substantial risk that the cost of equity is in fact below its true level. And as much as there are other tools that regulators can use to ensure minimum levels of service, none of these provides the same direct incentive for investment as the cost of equity.

   b) The second is the Ofgem and UKRN concept that a "through the cycle" approach to the cost of equity (and the total market return in particular) can be relied on whereby previous price control settlements can offset the current or future cost of equity being set at a level that is demonstrably too low relative to the market.

      i. Firstly, parameters such as the Total Market Return (TMR) have been substantially reduced in previous settlements and some aspects of their calculation have incorporated cyclical reductions, meaning they did not represent a fully "through the cycle approach". Further information on how regulators, including Ofgem, previously lowered their estimates of TMR in response to the fall in gilt yields, and wider market conditions, can be found in the Frontier Economics report: 'Equity Investability in RIIO-3', provided by the ENA.

      ii. Secondly, financial market conditions have fundamentally changed in the past few years and it is not reasonable to assume that cheap money will re-emerge at previous levels. This means that, on a prospective basis, making investments would be unattractive when financial markets are tight.

269. Beyond our points above, the ENA has provided Ofgem with several expert reports that give relevant detail on individual parameters of the cost of equity and cross checks, and we refer Ofgem to these.

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?

270. Ofgem should ensure that all of its proposed methodologies come together to set an appropriate cost of equity to attract the investment that is key to delivering Net Zero.

271. The ENA has provided Ofgem with several export reports on CAPM parameters, including the approach to establishing the real risk free rate; we refer Ofgem to these.

272. We have not identified any other material instances where Ofgem's proposed methodology has not been covered by the UKRN guidance or in previous price controls. If such issues subsequently become apparent, we will respond once this becomes clear or during future consultations.

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?

273. As set out in response to the questions above, the Net Zero context means Ofgem must avoid setting an equity beta that is too low. Excessive and mechanistic focus on specific comparators and timeframes for beta estimation at an early stage of a price control review would give rise to just such a risk. For example, periods of volatility in financial markets can give rise to equity beta estimates that are downwards biased; and recent data as well as data from the time of the global financial crisis shows evidence of this.

274. The ENA has provided Ofgem with several expert reports that give relevant detail on individual parameters of the cost of equity, and this includes the equity beta. We refer Ofgem to these reports as an additional element to our response.

275. Ofgem should also be cognisant of the heightened risk for all energy sectors in RIIO-3; this will be reflected in investors' perception of risk and should be taken into account to ensure equity returns reflect this.

Allowed WACC

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

276. No, and we agree with Ofgem's proposal to set allowed returns based on the Weighted Average Cost of Capital (WACC) and to assess financeability with reference to a notional capital structure.

277. We note that implementation options b) and c) in paragraph 2.46 of the 'allowed return on debt' section of the consultation document would create different 'notional' financing structures for each network company. Although these 'notional' financing structures would have consistent proportions of debt and equity, the relative proportions of fixed-rate and index-linked debt would be based, to some extent, on the actual company financing structure. This would be a concerning and important departure from Ofgem's long standing principle of focussing solely on the notional company and not on actual company financing. It is also unclear to us how Ofgem would take this into account in financeability assessments. This practical problem presents another reason

Ofgem should not adopt actual company proportions of real and nominal debt if it implements debt option 1 or 2. Our response to FQ3 provides further details on our opposition to the use of company specific approaches to an index-linked debt assumption.

FQ11. Do stakeholders consider there to be good reasons to deviate from the notional gearing assumptions (with respect to the level of gearing and the mix of debt types) applied to GD, GT and ET companies in the RIIO-2 price controls?

278. We agree that using RIIO-2 gearing levels as a starting point is sensible, subject to review following receipt of company investment plans.

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?

279. Yes – the proposal to assume that notional gearing levels are maintained for each year of the price control would align the interest payments assumed in corporation tax allowance calculations with the notional gearing assumption. It would also bring consistency with the tax clawback calculations which implicitly assume that interest payments included in the corporation tax allowance calculations are based on the notional gearing assumption.

280. Another advantage of the proposal is that it would avoid the need to establish a threshold at which it is assumed that equity would be issued.

281. Equity or debt issuance should be assumed to occur at the start of each year in notional debt calculations, and any assumed equity issuance should attract an equity issuance allowance in that year.

Financeability

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

282. A longer-term assessment of financeability (significantly beyond the forthcoming price control period) is required and should be completed in sufficient detail to capture the effect of regulatory asset lives and depreciation profile policies:

   a. It is not clear to us whether an 'economic form model' (referred to in paragraph 5.14) would capture this adequately. The basis of the longer-term calculations could be simplified rather than using an extended version of the full Business Plan Financial Model; however, any solution needs to be able to model future RAV and RAV depreciation reasonably accurately (accepting that future expenditure is uncertain), as this does not lend itself easily to extrapolation.

   b. Ofgem should look at a range of decarbonisation scenarios in its longer-term assessment, including the high and low scenarios in the range. Future uncertainty in other longer-term modelling parameters could be addressed using sensitivity testing, e.g., for WACC ranges.

c. Stress tests for the RIIO-3 period should cover the full range of plausible outcomes under totex uncertainty mechanisms.

283. Ofgem should take care to avoid any erosion of credit quality across the sector which could result from either targeting lower ratings or letting individual elements slip in an 'in-the-round' assessment. If headroom from the allowed cost of equity is insufficient to meet a given credit rating, and ratings slip, companies would then find it more expensive to raise debt and it may prove difficult to get back to a higher rating without concerted effort. It would be for Ofgem to make the case that any erosion of credit quality would represent value for money for customers, taking account of the likely increase in borrowing costs and additional financing risk it would induce in the sector. A lack of clarity around target ratings would be at odds with Ofgem's stated focus on financial resilience.

284. Ofgem needs to ensure consistency between calibration of the allowed cost of debt indexation methodology and its target credit rating. If calibration of the allowed cost of debt is predicated on companies achieving a given rating, it is incumbent on Ofgem to ensure that the notional efficient company can match that including each of the key credit metrics tests for that target rating. Ofgem should demonstrate this consistency explicitly as an element of its assessment and should provide a clear target credit rating.

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

285. We welcome the addition of investability as a key consideration – it is an inherent (and previously, frequently missing) constituent element of financeability. Investability should be focused on the viability of the equity investment proposition, rather than solely focussing on the debt investment proposition.

286. The assessment of investability should focus on cross-checks for the allowed cost of equity which use market evidence to assess whether the difference between the allowed cost of equity and the cost of debt is sufficient to compensate for the higher relative risk taken by equity investors.

287. In particular, we expect the most relevant cross-checks to be the asset risk premium relative to debt risk premium (ARP–DRP) framework and the use of market-observed data relating to hybrid bonds issued by National Grid. The ENA has provided Ofgem with several expert reports that give relevant detail on equity investability cross-checks. We refer Ofgem to these reports as an additional element to our response.

288. We would urge Ofgem to reflect carefully on the marked change in interest rate environment since the RIIO-ED2 was struck. This must be reflected in Ofgem's cost of equity for RIIO-3 to ensure there is an appropriate incentive for equity investors.

289. Investability is affected by regulatory asset lives and depreciation profiles, which is covered in our response to FQ25. Ofgem should review the long-term impact of asset life/depreciation policies in a way that shifts the focus away from technical asset life considerations and better considers overall outcomes for customers, and long-term financeability of network companies, which will include considering the impact of these policies on equity metrics.

290. Investability is also supported by ensuring that equity issuance allowances are sufficient and that dividend assumptions are not reduced as a financeability ‘lever’.

Financial resilience

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?

291. Ofgem, stakeholders, customers and investors must all be confident that dividends are only distributed in appropriate circumstances. The rules are primarily set out in the Companies Act and they apply to all companies. But to the extent network companies require additional restrictions, Ofgem has already thought about dividend policy carefully and developed a sensible combination of additional general and specific obligations. This is explained further in our response to FQ16.

292. Ofgem outlines three potential financial resilience measures under consideration. Below we detail our view on each.

293. Option one would amend the licence condition to “require” licensees to maintain more than one notch above investment grade rating rather than “use reasonable endeavours” or “all appropriate steps”. The supposed customer benefit does not outweigh the potential cost. It is outside of a licensee’s control to provide such certainty. For example, there could be Government changes that impact a credit rating agency evaluation, causing a downgrade for all licensees. There would be a material cost to customers if companies were to change their behaviours towards this position, without the certainty sought after by Ofgem ever being achieved.

294. Option two supplements the current dividend lock-up trigger, of reaching BBB- with a negative watch/outlook, with an 80% gearing-based trigger. In practice, we do not think this additional measure would have a real-world impact as the current measures prevent such high gearing levels. As Ofgem notes in the consultation, licensees are incentivised to remain below notional company gearing as the tax clawback provisions are triggered in circumstances where a company’s gearing is above the notional company’s gearing. It is also unlikely that this additional measure would change company behaviours as it is so rare that any company could be over 80% geared and remain above investment grade. If Ofgem were to either increase the rating at which dividends are locked-up by one notch, or alternatively to add in the gearing-based trigger, we agree that the gearing-based trigger would be the simpler, more transparent, and unlikely to impose material additional costs on companies and consumers.

295. Option three looks to amend the Availability of Resources requirement for board certification to require that the licensee states that, based on “agreed assumptions”, it has sufficient financial resources to cover the entire price control period or a minimum of three years ahead. As per our response to FQ16, the current certification requires licensees to look further ahead than 12 months. In practice, when the board is considering a dividend payment, under the licence obligations, they would, and should, look out as far as reasonably possible. We suggest that Ofgem solely clarifies its guidance stating the timeframe should be further out or amend the certificate wording so it states, ‘for the avoidance of doubt licensees should look ahead to the entire price control period’.

296. Ofgem should not attempt to define a set of "agreed assumptions" that will determine whether or not a company may declare a dividend. Attempting to prospectively define such a complex and inherently uncertain set of assumptions is an impossible task. Instead, the current arrangements sensibly put the onus on the company to make a considered judgement taking into account all the relevant information that is available at the time. This approach should be retained.

297. Overall, the current ring-fencing obligations give Ofgem everything it needs to ensure companies take long-term financial resilience into account when making any dividend payment. But there is room for Ofgem to make clearer their expectations in relation to those requirements, including the need for companies to look further ahead than 12 months when processing the Availability of Resources certification. If Ofgem were to make any forward-looking changes, which we don't think are required, an 80% gearing-based trigger will provide Ofgem with iron-clad finite protection – nothing else is required.

FQ16. Are there better ways to protect against excessive leverage and financial risks, in particular leverage via acquisition finance, by utilising existing powers rather than imposing new requirements in the licence?

298. The distribution of dividends to shareholders is a key part of the price control framework and a fundamental component of investor expectations. Investors have a legitimate expectation that dividends can be paid to an equity holder provided the licensee remains financially resilient. The regulatory regime has been appropriately set up in such a way to make that possible. This is particularly important in a world where investors are expected to raise new capital to deliver a substantial step-up in investment.

299. Ofgem, stakeholders, customers and investors must all be confident that dividends are only distributed in appropriate circumstances. The rules are primarily set out in the Companies Act and they apply to all companies. But to the extent network companies require additional restrictions, Ofgem has already thought about dividend policy carefully and developed a sensible combination of additional general and specific obligations.

300. Each DNO's licence contains 'ring fence' conditions which ensure that the licensee has adequate financial and operational resources to run its distribution business, protecting customers in the long term. The directors of the licensee must not declare or recommend a dividend unless the certificate required by SLC30.9 has been submitted to Ofgem which, essentially, certifies that the ring fence conditions in the licence are met. There are also other restrictions that ensure the licensees remain financially resilient.

301. The ring fence measures regarding the payment of dividends require the licensee to look further ahead than 12 months. The obligations are two separate, yet overlapping, controls which give a sensible answer where Ofgem has firm restrictions in place but also puts licensees in a position where they are able to fully comply. Directors of the licensee must:

    a. Evaluate any proposed dividend payment and certify that the making of that payment itself, or when it is taken with other reasonably foreseeable circumstances, will not cause the licensee to be in material breach of the specified licence conditions; and

b. Certify that the licensee's directors have a reasonable expectation that the licensee will have sufficient financial resources and financial facilities and operational resources respectively to enable the licensee to carry on the distribution business for a period of 12 months from the date of the relevant certificate.

302. In the context of the obligations on licensees, and therefore on the directors of the licensee who sign-off annually the certificate required by SLC30.9, it is hard to understand how anyone could construe the obligation to look ahead as being limited to only 12 months.

303. In practice, when the board is considering a dividend payment, under the licence obligations, they would, and should, look out as far as reasonably possible. The same timeframe will not apply to all factors that have to be considered, so each component will have different time horizons depending on the attributes of that component and how far out it is possible to project. But in the context of price control regulated businesses with multi-year price controls, long-lived assets, long-term financing instruments and investment horizons, compliance with the obligations will, in practice, involve longer-term projections when certifying that a licensee is compliant with the requirements of SLC 30.9.

304. Furthermore, Ofgem's reporting requirements are exhaustive. The Regulatory Financial Performance Reporting (RFPR) requires "licensees to provide an explanation of dividend policies and dividends declared and paid, and how these take account of long-term financial sustainability, including delivery for customers and other stakeholder obligations". We recognise that not all companies may have interpreted dividend certificate requirements and RFPR requirements in the same way. Therefore, we encourage Ofgem to clarify its expectation of how the current dividend obligations should be met. This includes the expectation that directors must necessarily look further ahead than 12 months when signing the certificate required by SLC30.9.

305. With that clarification, we believe that the existing arrangements would be highly effective in ensuring that all stakeholders have all the tools and information that they need. We believe that the introduction of any new, unnecessary changes to policies will harm consumers since they would inevitably and needlessly increase the cost of equity finance.

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?

306. It seems sensible for Ofgem to ask licensees to disclose contractual financing arrangements with their MidCo and/or HoldCo.

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?

307. It is not necessary for Ofgem to introduce stress-testing. Ofgem already has appropriate arrangements to ensure licensees are financially resilient. This is explained further in our response to FQ16. The issues in retail energy and retail financial services are fundamentally

different which severely limits any read across from the approach to financial resilience in those sectors.

Corporation tax

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

308. Yes, although we think that it would be better to assess the 'tax reconciliation' against a total materiality threshold for the price control period, rather than using a lower materiality threshold on an annual basis as is the case in RIIO-2. This would better allow for offsetting differences between years and reduce the likelihood of unnecessary 'tax review' work being undertaken.

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

309. Yes, the proposed revision to the definition of net debt recognises the economic equivalence of the cumulative accretion, net of paydown, associated with inflation-linked derivatives and net debt.

Regulatory depreciation and economic asset lives

FQ21. GD & GT: assuming re-openers are available and there is no adjustment to the allowed WACC, how should regulatory depreciation be used to address the uncertainty around the future path for gas and perceived asset stranding risk?

310. Ofgem should commit as strongly as possible to the long-term recovery of investments in regulated assets, in all network sectors.

311. This commitment will help reduce costs to customers by keeping the cost of capital as low as reasonably possible in all sectors.

312. To effectively demonstrate this commitment in the gas sector, and effectively minimise the upwards pressure on the cost of capital in that sector that could otherwise occur in that context, Ofgem should:

    a. Front load cost recovery, to reduce materiality of the longer-term recovery risk (and not just to recover costs as fairly as possible in proportion with the expected consumer use of the assets, although we agree this is an important consideration generally).

    b. Explore a potential recovery mechanism for any remaining, un-depreciated, assets at the point the assets are no-longer needed (irrespective of whether they can be repurposed), ideally consulting on and committing as strongly as possible to use one such approach (e.g., passing through residual capital charges for any gas assets into energy bills).

313. The stronger the commitment to a recovery mechanism, the weaker the need to front load cost recovery (beyond any front loading necessary to ensure an expectation of inter-generational fairness in cost recovery, when evaluated across multiple scenarios).

FQ22. GD & GT: what long-term path should regulatory depreciation aim to follow between 2026 and the assumed de-energisation point to promote fairness for current and future consumers? What unit metrics should this be based on? Is this resilient to the various scenarios under FES 2023?

314. We have not undertaken any detailed analysis of gas distribution and gas transmission network usage and unit charges that would allow us to contribute further to the analysis presented by Ofgem in the consultation.

315. However, our observation in FQ21 that Ofgem should consider using front loaded cost recovery in the gas sector to reduce the materiality of longer-term recovery risk, not just to spread costs fairly, would promote the use of a scenario with a relatively fast migration away from gas. This would make a significant contribution to mitigating the upwards pressure on the cost of capital that may otherwise be seen in the gas sector in the face of asset stranding risk, and so help to minimise costs to gas network users overall (taking current and future users together). The same mitigation could potentially also be achieved through the option we set out at paragraph 313b above, credibly committing to long term cost recovery of any stranded costs.

FQ23. GD & GT: assuming there is a relevant gas reopener for government policy, is there a need to reopen regulatory depreciation policy intra-period?

316. Regulatory depreciation policy should not be reopened intra-period as a general rule.

317. Changes to depreciation schedules tend by their nature to have a relatively slow and long-term impact. Ofgem therefore needs to factor this into its decision making at the current price review, as otherwise depreciation may not have sufficient time to have the desired effect.

318. Turning specifically to the gas sectors, if a new government policy means a short- or medium-term cliff edge in gas usage becomes highly likely, it may already be too late to address this significantly through a change in depreciation policy – unless Ofgem has already set depreciation schedules anticipating this policy (and if Ofgem has done this it should make a reopener essentially un-necessary).

319. If alignment between the RIIO-3 regulatory depreciation method/values and the outcome of any government policy reopener is a material concern for GD3 or GT3, then the method by which this alignment would be achieved needs to be set out clearly as part of the RIIO-3 price control package. Ofgem should resist retaining an open-ended option for depreciation policy change. Instead, it should set out in detail the specific changes it would make to gas sector depreciation schedules to address potential policy shocks, in order to promote a clear understanding of how regulatory asset stranding risk is being mitigated; and insofar as a reopener is considered necessary, the detailed triggering circumstances, and changes to depreciation that would follow, should be explicitly included in the reopener (making it more akin to the normal operation of the licence).

FQ24. GD & GT: what considerations are raised by asset repurposing and how might these affect the decisions to be made on regulatory depreciation policy? What guidance is sought for the SSMD so that licensees have sufficient clarity for their business plans?

320. Until such a time as wide-spread asset repurposing appears likely, we do not think it should be relevant to decisions on regulatory depreciation. The depreciation policy should be set to ensure that residual risks to the RAV are relatively small, in order to constrain increases in the necessary cost of capital that may otherwise occur. Placing material reliance on uncertain asset repurposing would undermine this objective.

321. We also note that the Consultation appears to assume that asset repurposing would be achieved through sale of the assets to a new provider. We think there would be advantages to energy consumers in a position that starts from a presumption that the existing licensed entity would repurpose the assets themselves.

322. This would not necessitate a role for Ofgem in regulating the activity; it would only need to recognise it as an additional revenue stream within the overall regulated network entity, and require the regulated entity to allocate reasonable costs to the new activity. Where repurposing is undertaken, this would enhance business and regulatory continuity, and thus again help avoid a disruptive factor that could increase the cost of capital of the regulated businesses (and would be costly to energy consumers, to whom Ofgem must have regard). If the overall energy and regulatory framework currently acts to prevent this, potential changes to the framework could be considered; for example changes to the gas transporter licence to accommodate the new activity alongside the existing gas transportation activity may be sensible.

FQ25. ET: do stakeholders consider there to be a need for amending the existing RIIOET2 asset life and/or profile assumptions, on either a company-specific or sector basis? If so, please set out your evidence base and potential consumer benefits and costs of changing the existing methodology.

323. Our response to this question is based on our analysis of the electricity distribution sector, which could potentially be applicable to the electricity transmission sector (although we note the different profiles of investment in the sectors could substantially alter the prominence of specific issues between them).

324. We support Ofgem's statement at paragraph 8.4 of the consultation that "the key principle for inter-generational fairness is that the rate of depreciation should be set so that different generations and types of consumer pay network charges broadly in proportion to the value of network services they receive."

325. Ofgem is however incorrect to follow the above statement on intergenerational fairness with its claim that "If we assume the current network will continue to deliver useful service only over the next 50 years, then the RAV should be depreciated over 50 years." This would ensure the principle of intergenerational fairness would be met **if and only if** investments had historically been depreciated over 50 years. Instead, if historical investments have been depreciated more quickly, and paid down rapidly by the previous generation, using a 50 year assumption would result in the current generation (for the next 30 years or so) paying network charges that are a lower proportion of the value of the network services they receive, when compared both to the previous generation and to future generations.

326. This issue means that Ofgem's current regulatory depreciation policies in electricity distribution violates its principle of inter-generational fairness; the same issue may potentially arise in

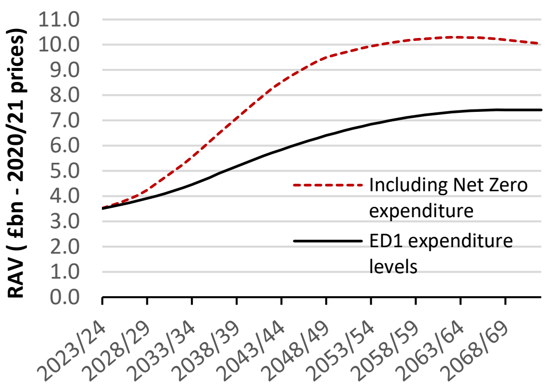
electricity transmission (although differences in investment profiles over time may mean the issue is less pronounced in that sector).

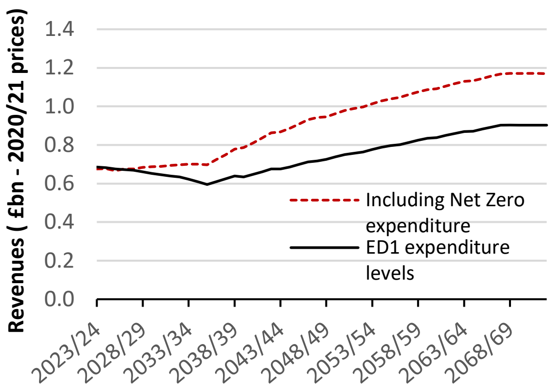
327. Ofgem should therefore explicitly recognise the impact of depreciation policies in previous price control periods on the level of charges for today's customers in its policy considerations.

328. The impact of asset lives and regulatory depreciation policies on both short and long-term financeability metrics also needs to be given sufficient weighting when deciding on these policies, to avoid creating upwards pressure on the cost of capital (and hence avoiding higher costs for current and future network users, taken together).

329. For the electricity distribution sector, the profile of depreciation needs to be accelerated significantly in RIIO-3 to avoid issues with intergenerational fairness, and with financeability and equity metrics, caused by the change from 20-year to 45-year asset lives in ED1.

330. Ofgem's current 45-year asset lives policy raises serious questions about the long-term sustainability of RAVs in the sector. Long term RAVs more than double under a 45-year asset life, even when expenditure associated with the Net Zero transition is excluded. The charts below illustrate both the growth in RAV, and the potential growth in charges, for a Northern Powergrid scale DNO if the current 45-year asset life policy remains. Revenues have been calculated assuming RIIO-ED2 levels of WACC.





331. Our analysis for electricity distribution shows that the change in asset life from 20 years to 45 years during ED1 has resulted in today's customers benefitting from lower bills at the expense of future customers. Lower RAV depreciation (and therefore customer bills) in the short term, with consequential growth in the RAV, leads to significantly higher costs for customers in the future. This is before factoring in the additional costs associated with the transition to Net Zero.

332. Under Ofgem's current policy, cash flows in the electricity distribution sector will become significantly strained in the 2030s, with financeability metrics falling below investment grade level.

333. If Ofgem's current 45-year asset lives policy is maintained, the investability of the electricity distribution sector will dramatically decline over the long term, at a time when significant investment is required to meet net zero targets. The impact on equity metrics illustrates this point well. As we head through the 2020s and into the 2030s, net income projections decline year on

year under 45-year regulatory depreciation, driving the return on book equity to low single figure percentages. Ofgem would then be locked into long-term price rises, ultimately leading to a period in which returns on book equity rise above 20 per cent, creating enormous scope for public and political pressure on the regime (and in turn raising the cost of equity). This is simply unsustainable.

334. We are yet to see any analysis from Ofgem on this critical issue for customers and the sector.

FQ26. If a 'semi-nominal' cost of debt and WACC approach were to be adopted which results in an acceleration of cashflows, would this impact your responses to any of the questions above?

335. Our responses to the above questions would not be impacted by any change to a 'semi-nominal' WACC approach, although we recognise that the combined impact of all policies which change the timing of cash flows needs to be considered in the calibration the price control package as a whole.

336. Based on our analysis for the electricity distribution sector, changing to a 'semi-nominal' WACC approach would not advance cash flows sufficiently to address the significant issues caused by the change from 20-year to 45-year asset lives in ED1.

337. In any event, as per answer to question FQ2 and FQ3, there is no justification to change the basis on which inflation is accounted for in debt costs. To claim that such a change should be made in order to address the speed of cashflows would simply be using the wrong tool to achieve an outcome that should properly be made through adjusting asset lives and regulatory depreciation policies, as we have argued consistently for some time.

338. Ofgem could use asset lives and regulatory depreciation policies, and totex capitalisation rates, as tools to accelerate cash flows without the complexities arising from any change to a semi-nominal cost of debt and WACC approach.

Return Adjustment Mechanism (RAMs)

FQ27. Do stakeholders have views or evidence as to why RAMs should or should not continue?

339. We do not think Return Adjustment Mechanisms (RAMs) should be used. If Ofgem takes good decisions on the appropriate design and calibration of each element of the price control, then the overall package should make sense and RAMs should not be needed. They are a blunt mechanism placed on top of what should be carefully made decisions, that might have the effect of switching off carefully designed incentive mechanisms.

340. However, if RAMs are to be used, the calibration must give companies clear financial incentives to improve performance. Companies that do not hit fair performance targets should face penalties, while companies that perform well and deliver benefits to consumer must be permitted to benefit through the calibration of incentives giving sufficient headroom over the allowed return on equity.

341. If performance bands are too narrow, one effect would be to curtail the important incentive provided for the leading firms (those outperforming the most) to keep driving performance

forward in customers' interests. This may prevent best practice from being discovered, at a potentially significant cost to all consumers.

FQ28. Do stakeholders have views or evidence as to whether the RAMs methodology should be amended, such as recalibrating the threshold or rates or including financial performance?

342. If RAMs are used, they should be calibrated at the draft determination stage, in order to minimise the danger of negative effects such as disincentives to drive performance forward. Design of the overall price control package, and incentives within that, should be concluded before setting thresholds.

343. Financial performance should not be included. This would amount to a sharing factor on the cost of debt through the back door and a five-year price control period does not provide an adequate timeframe for measurement of financial performance.

344. The definition of Output Delivery Incentive (ODI) performance included in the RAM assessment should include the impact of guaranteed standards payments.

FQ29. Do stakeholders have views or evidence as to whether there should be separate RAMs for 'BAU' parts of the business and specific programmes, such as ASTI?

345. Ofgem should first look to carefully calibrate the overall package; if it gets each element right there is no need for a RAM.

346. As the purpose of RAMs is to 'provide protection to customer and investors in the event that network company returns are significantly higher or lower than anticipated', it is the overall level of operational RORE performance that is important and there should be no need to split this into separate components if both individual incentives and the RAMs thresholds are appropriately calibrated.

347. If a cap on exposure to any particular element of the price control package is required, that should be put in place separately to RAMs, as is generally the case with output incentive mechanisms. Overall RAMs thresholds should be set once all of the individual elements have been calibrated, to allow proper assessment of the impact and to avoid unintended consequences from RAMs.

348. Ofgem should ensure the RAM is calibrated at a reasonable level relative to the scale of the business it is being applied to; so if a particular business is experiencing a substantial increase in activity or overall expenditure (relative to the size of its existing RAM thresholds, which are based on RAV) then this might suggest a wider calibration is appropriate. Ofgem can take this into account at draft determinations when it proposes the relevant parameters and after it has assessed business plans. This would ensure the RAM does not weaken incentives for companies to drive benefits for customers, with no need to set separate RAMs. Network companies should then be left to manage the risk of relative performance on significant programmes and business-as-usual activities.

Other finance issues: Capitalisation rates

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

349. As a general principle, we think that it is preferrable to have a single capitalisation rate for totex, set ex-ante, in order to avoid distortions in incentives between opex and capex solutions. It therefore seems sensible to explore whether the multiple bucket approach could be removed.

350. However, we recognise that if a significant proportion of allowances are likely to be covered by uncertainty mechanisms, maintaining a split capitalisation approach may still be appropriate for one or more sectors.

351. In sectors where companies operate similar networks, Ofgem should review capitalisation rates to drive consistency, avoiding differences caused by variations in accounting policies or different calculation methods.

352. Ofgem's view that setting the regulatory capitalisation rate accurately 'ensures that charges over time are fair to existing and future customers' (paragraph 10.3 of the consultation), risks an unhelpful focus on increasing levels of perceived accuracy in this area as opposed to considering overall totex capitalisation in the wider context of intergenerational fairness. See our response to Ofgem's consultation questions on regulatory asset lives and depreciation, covered in FQ23 to FQ26.

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?

353. We oppose the use of outturn capitalisation rates, even in part (as is suggested in this option).

354. A partial true-up to outturn capitalisation rates would exacerbate issues already caused by setting inconsistent company-specific ex-ante capitalisation rates. It would further undermine the totex approach to regulation, since licensees' RAV growth would then be influenced by whether they choose capital heavy or capital light solutions in expenditure decisions taken within the price control period, in addition to the influence of the equivalent choices made for business plan submissions on the ex-ante rates.

Other finance issues: Directly remunerated services questions

FQ32. Are there any reasons why the RIIO-3 approach to directly remunerated services should differ from RIIO-2?

355. There is an issue with the way DRS10 income and costs forecasts were used in setting RIIO-ED2 totex allowances which may have relevance to other sectors. For RIIO-ED2, forecasts for DRS10 were simply deducted from totex allowances as a post benchmarking adjustment ('Price Control Financial Model (PCFM) adjustment'). This treatment (if understood in advance) could incentivise companies to include a low forecast of such income, as there would be no impact on the totex benchmarking results from doing so.

356. In principle, any such adjustment (if required) should be made prior to benchmarking. Ofgem should also ensure that its policy intent is clear regarding whether the totex incentive mechanism sharing factor will apply to the full value of any net income, or just the difference between actual and forecast values.

FQ33. Do stakeholders have any reasons or evidence to suggest more directly remunerated service categories are necessary?

357. Ofgem and the relevant sectors are best placed to give comment and evidence to this, as it is sector specific.

Other finance issues: Disposal of assets

FQ34. Do stakeholders have views or evidence in support of or objection to treating all asset disposals as fast money? Would the existing or alternative approaches have greater merit?

358. We believe that the current treatment of asset disposals as negative totex is appropriate as it:

    a. ensures incentives are equalised between asset investments and asset disposals – so choices to dispose of one asset (potentially replacing it with another) are not distorted; and

    b. gives licensees an incentive to maximise the proceeds from disposals, while ensuring the benefits are shared with energy consumers.

359. The consultation is silent on the treatment of forecast disposals proceeds in setting totex allowances. At RIIO-ED2, Ofgem deducted forecast disposals proceeds from totex allowances as a post benchmarking adjustment. The RIIO-ED2 approach therefore offers no incentive for companies to include their best forecasts of disposals proceeds. We question the need for any such deduction from allowances if Ofgem's policy intent is to allow sharing of proceeds between customers and network operators but, if an adjustment is to be made, it should be made prior to benchmarking and Ofgem should make its policy intent clear.

360. We do not believe that it would be in the interests of consumers to treat the incentivised disposal proceeds as fast money:

    c. Given that regulatory asset lives have historically been much lower than technical asset lives, it is unlikely to be the case that today's customers are still paying for assets that have been disposed of.

    d. The change in cash flow profile resulting from disposals proceeds being treated as fast money might disincentivise a company from disposing of an asset and replacing it with another, even if this were the lowest-cost solution.

    e. It will add further complication to price control calculations.

FQ35. Do stakeholders have views or evidence as to what reporting information should be provided to Ofgem (under the RPFRs or other forms) to ensure objective identifiability of repurposed assets and cost data remains appropriately like-for-like?

361. Ofgem and the gas networks are best placed to give comment and evidence to this, as it is sector specific.

Other finance issues: Transparency through RIIO-3 reporting

FQ36. Do you consider that the existing reporting requirements on executive pay/remuneration, dividends and corporate governance previously introduced for RIIO-2 price controls remain appropriate in helping demonstrate the legitimacy and transparency of company performance?

362. The existing RIIO-2 reporting requirements in these areas are extensive. For example, in respect of dividends, the Regulatory Financial Performance Report (RPFR) guidance requires licensees to "provide an explanation of dividend policies and dividends declared and paid, and how these take account of long-term financial sustainability, including delivery for customers and other stakeholder obligations". Executive remuneration disclosures already go beyond what is required. Ofgem has put in place price controls that ensure licensees are incentivised to keep all costs as low as possible; this includes executive remuneration. We will continue to work with Ofgem to ensure all reporting requirements are met, but we see no reason for any further expansion of requirements.

363. Paragraph 10.34 of the consultation notes an issue with 'levels of compliance and completeness against reporting requirements' in RIIO-2 RFPR returns being 'noticeably variable'. Ofgem should work with network companies to address these issues before considering any further changes.

FQ37. Do you have any other suggestions for clarifying or strengthening the reporting requirements with regard to executive pay/remuneration, dividends or corporate governance?

364. No. As we made clear in our RIIO-2 consultation responses the additional reporting requirements already put in place are not appropriate.
    a. Ofgem should not require licensees to publish details of executive remuneration.
    b. Ofgem's argument that publication is required because the licensees are natural monopolies and regulated companies doesn't stand scrutiny.
    c. Ofgem should also consider the risk that this will place upwards pressure on the pay of executives at companies that have managed their executive pay most efficiently, by revealing pay rates across the market.

365. Ofgem should consider gathering the information at an aggregate level for each licensee, as that would be more appropriate. Any additional reporting requirements with regard to dividends are also not required.

366. Ofgem's reporting requirements are exhaustive. The Regulatory Financial Performance Reporting (RFPR) requires "licensees to provide an explanation of dividend policies and dividends declared and paid, and how these take account of long-term financial sustainability, including delivery for customers and other stakeholder obligations". We recognise that not all companies may have interpreted dividend certificate requirements and RFPR requirements in the same way. Therefore, we encourage Ofgem to clarify its expectation of how the current dividend obligations should be met. This includes the expectation that directors must necessarily look further ahead than 12 months when signing the certificate required by SLC30.9.

367. With that clarification, we believe that the existing arrangements would be highly effective in ensuring that all stakeholders have all the tools and information that they need. We believe that the introduction of any new, unnecessary changes to policies will harm consumers since they would inevitably and needlessly increase the cost of equity finance.

Other finance issues: Annual Iteration Process and financial modelling issues

FQ38. Do you have any suggestions on how to improve and future-proof the price control financial model, or use cases it could better support?

368. In considering potential development of the PCFM, the role of the PCFM as a licence instrument should be carefully balanced with making the PCFM more useful to stakeholders. Ofgem should be mindful of the resource burden associated with any additions to the PCFM required for self-publication. Instead, this might best be achieved by retaining a PCFM with the required calculations of allowed revenue (and RAV) only and having a separate related model containing any additional calculations and functionality beyond the current scope of the PCFM.

FQ39. What are your views on allowing licensees to self-publish the PCFM with their charging statements, rather than relying on an Ofgem publication or direction to determine allowed revenue?

369. Self-publication of the PCFM is already in place in RIIO-ED2 and worked well for the 2023 AIP.

FQ40. What are your views on applying a single time value of money in the financial model to all prior year adjustments, based on nominal WACC?

370. We agree with the use of the nominal WACC via a single time value of money adjustment, which is the methodology in place for RIIO-ED2.

ET Annex

Delivery of major new projects

371. We do not have any comments on the specifics on major investments in the electricity transmission sector. The choice and design of the mechanism is best explored by Ofgem and electricity transmission network companies.

Load related expenditure outside of the CSNP

ETQ7. What are your views on our proposal for load-related expenditure outside of the CSNP, how these mechanisms can be improved and streamlined, and the appropriate thresholds for the mechanisms?

372. Where it can, Ofgem should make use of ex-ante funding for load-related projects, such that network companies are able to deliver on all credible future pathways to Net Zero. This will also incentivise electricity transmission networks to carry out investment at the lowest cost to customers.

373. Ofgem should have a high bar for introducing reopeners, only applying them where there is a clear trigger. Applying a reopener wherever there is cost uncertainty is to broad a description and risks inefficient delivery of investment.

ETQ8. What are your views on our proposal for 'shared drivers' projects, how TOs need to evidence investment requirements and how they can be held to account for delivery?

374. These will likely require an EJP to ensure companies can evidence that they are choosing to complete the most cost effective solution given the multiple drivers of the project.

ETQ9. What are your views on our proposal that there is a need for generation and demand connections volume drivers in RIIO-ET3, and how, if at all, they should change relative to those used in RIIO-ET2?

375. Where implementing volume drivers, Ofgem should ensure the mechanism maintains strong incentives for networks to control their costs and that submissions facilitate consistent cost benchmarking.

376. Ofgem should give ex-ante allowances alongside volume drivers. There must be a degree of volumes that can be forecast to a relatively certain degree; ex-ante funding associated with this will give networks a strong incentive to find volume efficiencies alongside cost efficiencies. The volumes associated with the ex-ante allowance must be to a level that will allow for the enabling of a fast-moving pathway in future price controls beyond RIIO-3. Otherwise, the risk of disallowances will hold back investment and risk networks becoming a blocker if an ambitious pathway materialises.

Minimising networks' impact on the environment

ETQ10. What are your views on our minded-to proposal of retaining the IIG ODI-F during RIIO-ET3, and our additional commentary around the incentive and its associated reporting requirements?

377. If SF6 leakage can be directly, objectively and accurately measured it is a good candidate for direct financial incentivisation. Whether or not a financial ODI should be applied will depend on sector specific considerations.

378. Where the financial incentive is applied, Ofgem should:

   a. Set an evidence based target that it expects to result in an accurate settlement.

   b. Ensure the incentive operates on both sides of this level, by applying both a penalty and a reward.

   c. Only apply a deadband after rewards start to be earned; a wider incentive range and lower incentive rate is preferable to a deadband to optimise performance.

379. In our view, the Insulation and Interruption Gas (IIG) ODI-F should be limited to SF6 emissions if other IIGs do not have the same damaging environmental impact as SF6. If this is the case, then including their leakage in the measure could lead to perverse incentives and:

a. discourage the development and deployment of alternative IIGs, strongly if the leakage rates of the alternative tend to be higher for any reason; or

b. over-incentivise leakage prevention for assets with alternative IIGs if the environmental consequences of this leakage are negligible by comparison with SF6.

380. If the roll-out of these alternative IIGs was reasonably predictable, the declining volume of SF6 of the system (and therefore declining volume of leakage) could be recognised in declining leakage targets.

381. If however there is material uncertainty over the scale and timing of roll out of low environmental impact IIGs, Ofgem will have to consider carefully how to set targets for SF6 leakage.

ETQ11. What are your views on retaining funding to support mitigation projects that reduce the visual impacts of existing infrastructure in designated areas?

382. We agree that visual amenity costs lend themselves to UIOLI allowances. We would question whether any funding accessed through a re-opener should be subject to a PCD. Maintaining the use of UIOLI allowances would ensure customers benefit from the intended project without introducing the resource burden and associated costs through a PCD.

383. We do not believe that visual amenity funding of new projects should be limited to cases where it is necessary to obtain planning permission in today's planning standards. For example:

a. The incremental cost of undergrounding a new line, compared to building an overhead line, will be significantly lower than the cost of undergrounding a pre-existing line; therefore even if the visual amenity benefit is lower, undergrounding a new line might be better justified.

b. Consumer willingness to pay may indicate that undergrounding is justified in some cases where planning permission would be granted, if planning decisions do not fully capture this consumer willingness to pay.

c. Whether or not planning permission can be gained may potentially depend on factors like whether there are pre-existing lines nearby (depending on planning rules). This may prevent gradual removal of infrastructure because the presence of multiple lines may mean new lines could gain planning permission.

384. Updated analysis on willingness to pay would be helpful to help inform evidence based decision taking on the scheme. This would give Ofgem the confidence to maintain the funding for works associated with existing projects.

385. Willingness to pay information may also help justify removal of any distortion between funding to underground existing infrastructure and new infrastructure. To ensure the funding is targeted, it should be possibly to deploy it flexibly based on relevant evidence of amenity priorities.

ETQ12. Do you agree with our assessment of the bespoke outputs described in Table 7?

386. We do not have any additions to Ofgem's assessment.

Compliance with safety legislation

ETQ13. Do you agree that we should retain the RIIO-ET2 approach to safety, or do you consider there is anything more we could do?

387. We agree that the RIIO-ET2 approach to safety should be retained. The primary output for safety for the transmission operators (TOs) to comply with their legal safety requirements is appropriate and therefore we do not consider there are changes or additions that are required.

Network Access Policy (NAP) LO

388. The choice and design of the licence obligation is best explored by Ofgem and electricity transmission network companies.

Energy Not Supplied (ENS) ODI-F

389. The choice and design of the mechanism is best explored by Ofgem and electricity transmission network companies.

ETQ17. Would a change in the estimate of the VoLL impact TOs investment decisions, and should the incentive value methodology be updated if the VoLL is changed?

390. We believe that Ofgem should update the estimate for Value of Lost Load (VoLL) to reflect increasing reliance on electricity for customers. The change in VoLL may be material enough to influence TOs investment decisions.
391. If this change significantly alters the incentive value, Ofgem could make use of a scaler to give the intended strength.

Connections incentives

392. The choice and design of the incentive is best explored by Ofgem and electricity transmission network companies.

SO:TO ODI-F

393. The choice and design of the incentive is best explored by Ofgem and electricity transmission network companies.

New Infrastructure Stakeholder Engagement Survey ODI-R

ETQ28. What are your views on whether and how TO customer service performance should be incentivised or enforced during RIIO-ET3, over and above the incentives and obligations described elsewhere in this chapter?

394. The improvement and strengthening of the qualitative aspects of the customer performance measures set out in the chapter adequately address the issue of satisfaction. We believe that broad brush incentives, not linked to specific services or functions can be difficult to accurately measure and respond to as demonstrated in RIIO-GT2. As a result, we do not feel that a new Infrastructure Stakeholder Engagement Survey ODI-R is required.

CSNP Coordination

395. The choice and design of the licence obligation is best explored by Ofgem and electricity transmission network companies.

Evolving the RIIO-ET2 approach to cost assessment for RIIO-ET3

396. Ofgem and electricity transmission companies are best placed to design the detail of the cost assessment. We therefore do not provide a specific response to questions ETQ33 to ETQ36; we set out the principle-based hierarchy of cost assessment methods in our response to GDQ60.

ETQ31. Do you have any views on how the cost assessment methods used in RIIO-ET2 for load and non-load capex could be improved and/or simplified for RIIO-ET3? Do you think we should consider alternative and/or supplementary approaches to the assessment? If so, which?

397. The key to improving cost assessment, particularly in load-related expenditure, is to ensure that the initial submissions are completed on a consistent basis. This is dependent on agreed reporting tables, supported by robust definitions and clear direction on key assumptions, such as decarbonisation pathways as well as funding mechanisms. Ofgem's move to the use of a common pathway will allow for significant improvement on RIIO-2; it must not forget that the lack of provision of a common set of uncertainty mechanisms caused significant normalisation issues at RIIO-2.

398. Ofgem and electricity transmission companies are best placed to design the detail of the cost assessment. We set out the principle-based hierarchy of cost assessment methods in our response to GDQ60.

ETQ32. Linked to ETQ30, do you have any views on how the cost assessment process could be adapted to capture multiple drivers and address the needs of evolving cost categories for 'shared drivers' schemes?

399. Where there are multiple drivers associated with a project, Ofgem should set up its cost assessment to give electricity transmission operators the opportunity to evidence that it proposes the most cost-efficient solution given the drivers, for example via an EJP for the scheme.

400. Our response to Ofgem's proposed approach to reopeners is set out in the Managing Uncertainty section of our response.

ETQ37. Do you have any views on how to evolve MEAV as a scale driver for RIIO-ET3? What other scale drivers could we consider?

401. Ofgem and electricity transmission companies are best placed to design the detail of their Modern Equivalent Asset Value (MEAV), making the relevant exclusions (on both the cost and driver side) where data is inconsistent.

402. Ofgem should look to control for differences in indirect costs due to factors other than MEAV through the use of additional exogenous cost drivers, as opposed to trying to adjust MEAV in the first instance.

ETQ38. Do you have any views on how the cost assessment process could address the market volatility and supply chain challenges that the sector is facing?

403. Real price effects mechanisms should be constructed to capture all cost areas that are exposed to volatility in the markets driven by external factors, which network companies have no or extremely limited control over.

ETQ39. Do you have any views on our initial thinking around the role and potential evolution in RIIO-ET3 of the UMs listed in Table 9?

404. The specific choice and design of the sector specific mechanisms is best explored by Ofgem and electricity transmission network companies.

ET Business Plan Data Templates

ETQ40. We invite views on current reporting requirements and structure at the cost category level and how this may be adapted to better suit RIIOET3 and related development of BPDTs.

405. Without working knowledge of the current reporting requirements, we are not in position to provide any specific views on this.

GD Annex

406. We have given principle-based feedback on uncertainty mechanisms, outputs and incentives in our executive summary and in response to the Managing Uncertainty section of the overview document.

407. The specific choice and design of the sector specific mechanisms is best explored by Ofgem and gas distribution network companies with a sector specific understanding – but we have provided our perspectives as an electricity distributor network below, where we think they may be relevant.

Proposed RIIO-GD3 specific outputs and uncertainty mechanisms

GDQ35. What are your views on the options we've set out to incentivise customer satisfaction during RIIO-ED2?

408. There is greater value in promoting collaboration across all networks through a framework that sets the desired and expected standard that can be achieved by all, opposed to one that mirrors an open market where only the best performer(s) benefit. Going down the proposed route would likely starve collaborative working, broaden the gap between networks and make it more difficult for those lower scoring networks to recover given there would be a resistance to sharing best practice from top performing networks (even if a minimum standard backstop was imposed). In addition, one would expect a more inconsistent service offering to customers dependant on their location.

409. A penalty only ODI-F would likely be ineffective and could lead to an approach where networks do the bare minimum and only invest "enough" into their service offering only to avoid said penalty. For example, there may be improvements identified that would benefit the customer

but there is no desire to implement given the financial implications of doing so with no financial benefit. The only way that this approach would lead to improved customer satisfaction is if the bar was raised to a height (above the average achieved in RIIO-GD2) that it forced networks to aim for exceptional performance levels but at the risk of penalising those that provide what is still considered a good service.

410. If the current mechanism in place has had the desired effect and resulted in improved levels of customer service throughout RIIO-GD1 and RIIO-GD2, and at the same time narrowing the variance in service levels across the networks, then this seems to be the best option. By recalibrating the levels for penalty, deadband, and reward, networks would be incentivised to maintain the high levels of customer satisfaction that is currently being demonstrated without necessarily receiving financial awards. However, the reward that is available for exceptional levels of service will likely act as motivation to still look and drive towards continuous improvement. Whereas the penalty will deter networks from simply standing still or regressing. Given that this approach would be on the table for all networks, it would be in their best interest to work collaboratively and share best practice going forward.

411. One approach could be, in similar fashion to RIIO-ED2, to apply differing levels of weighting across the service types if there is a desire to improve performance in specific areas. If Ofgem were to go down this route for gas distribution, it would have to be mindful that this method can be influenced by sample size.

GDQ36. What are your views on how the complaints metric can ensure customers' complaints are resolved quickly and effectively?

412. The complaints mechanism works well; we do not think a reward mechanism is necessary.

413. The fact that no network has been penalised in RIIO-GD1 and RIIO-GD2, nor have been close to receiving a penalty, suggests that there may be some scope to tighten the targets.

414. The current mechanism drives networks to resolve complaints quicker, and in doing so indirectly incentivises networks to reduce the total number of complaints to a manageable level through actively improving customer service. We agree that the total volume of complaints as a percentage of customers should not have a financial incentive attached to as its improvement is already indirectly incentivised through the complaints incentive, and a blunt financial incentive element on this measure may give perverse incentives for companies to make it harder for customers to make a complaint.

415. The separation of Priority Service Customer (PSR) complaints would be useful to see, but we would not propose setting separate incentive mechanisms. Each network company must not be incentivised to prioritise complaints from PSR customers; all customers must be treated equally within this incentive.

416. There should not be any relationship between Complaints and the Customer Satisfaction survey (C-SAT). The example given is that high customer satisfaction could be rewarded in tandem with a penalty under the complaints ODI-F, to the extent that the gas distribution network (GDN) receives a net reward across the incentives. This link would risk introducing an element of double jeopardy if the C-SAT reward is reduced when a network hits penalty territory for complaints. A

customer making a complaint who then goes on to be surveyed (the fact that they have an open or closed complaint shouldn't negate them from going to survey), is unlikely to give the company a good score, so the impact of the negative experience would be factored into the C-SAT results already in a proportionate manner. The error rates built into the sample sizes for survey are there to make sure that the results are representative of satisfaction levels across the entire customer base. That should not then be influenced by a smaller sample of customers who have made a complaint regardless of how effectively they have been dealt with.

Proposed RIIO-GD2 outputs and uncertainty mechanisms proposed for removal

GDQ48. Should personalising welfare services continue to be supported under RIIO-3 and, if so, how should it be funded?

417. The option of a UIOLI allowance allows GDNs to consider what is right for their customers.

Options for evolving our cost assessment approach for RIIO-GD3

GDQ50. What are your views on the potential advantages of using multiple totex regression models in RIIO-GD3?

418. Where there are several potential totex models with strong and intuitive statistical results, all based upon strong economic and engineering rationale, there is merit in using multiple models to give multiple views of efficient costs.

419. However, one should not use additional models where there is a clearly superior model for the sake of using an average.

420. Each totex model used must be justified on its own merit and, at a minimum, should be weighted equally as a single view of efficient costs alongside any mid-level or disaggregated modelled view, upholding the benefits of totex regulation.

GDQ51. What alternative cost drivers and model specifications would you propose for early testing?

421. We are supportive of Ofgem's principles for choosing cost drivers.

422. In determining the totex model specification(s), we would encourage the use of exogenous cost drivers. This ensures the model incentivises companies to reduce costs in an efficient way, as opposed to the use of endogenous drivers that reward those who submit higher volume forecasts, and gives the strongest possible cost incentives.

423. If a Composite Scale Variable (CSV) is required to combat the limitations of having a small sample size, Ofgem should use pre-regressions to determine the weights within the CSV. It is bad practice to impose weights on each driver, as this does not let the data speak through the regression.

GDQ52. What are your views on the potential of middle-up modelling in RIIO-GD3?

424. The small sample size within the gas distribution sector may be a hurdle to the construction of any modelling more granular than a totex model. But we do recognise that an advantage of the middle-up approach is that different drivers could potentially be used for different parts of the

cost base, and transparently assessed and tested. In doing so Ofgem must avoid any temptation to use endogenous or workload driven cost drivers, as endogenous drivers damage efficiency incentives.

425. In investigating the possibility of the introduction of middle-up modelling in this sector, Ofgem should make use of the cost pool criteria from RIIO-ED2:

    a. Complementary costs, and costs that can be traded off against one another, should ideally be grouped in the same pool.

    b. The cost boundary must be well defined in the data reporting.

    c. The cost pool models should incentivise efficiency.

426. Ofgem must be mindful that a totex model will always perform better on the cost boundary criterion than any mid-level model, and a mid-level model will always perform better on the efficiency criterion than any granular model that only assessed unit cost efficiency.

GDQ53. What are your views on the potential of disaggregated modelling in RIIO-GD3?

427. Ofgem must take into account the regulatory burden of this, along with the potential damage to totex efficiency incentives, against any benefits that such a level of granularity brings to the cost assessment.

428. A higher-level mid-level model may give Ofgem the level of detail it seeks. Ofgem must be cautious not to go to such a level of granularity that it breaks the cost pool criteria and relies on the use of modelling techniques that do not incentivise totex efficiency.

GDQ54. In your view, what is the most suitable configuration of cost activities for middle-up or disaggregated modelling, that once combined, could form a complete bottom-up assessment of totex?

429. We would recommend high level cost pools, such as directs and indirects, provided the allocation of cost categories within these uphold the criteria outlined in our response to GDQ52.

430. In deciding whether to use more than one totex model, or make use of a more granular cost assessment, we support Ofgem's selection criteria for implementing a change from the RIIO-GD2 single totex model – but would add two more that should be prioritised.

    a. Chosen models must promote overall efficiency and create the right totex incentives.

    b. The resource cost of implementing the model must be proportionate.

GDQ55. What do you think would be appropriate criteria for determining cost exclusions for RIIO-GD3?

431. To maintain the benefits of totex regulation, Ofgem must have a high bar for exclusions and any exclusion should be made consistently across costs and drivers.

432. Ofgem is proposing to exclude costs where they "are not explained by the cost drivers used, or where there is a substantial change in the nature of the activity being undertaken" (paragraph 5.47 of the GD Annex of this consultation). The criteria needs to be stricter than this.

433. Ofgem should not exclude costs where there is lack of a relationship between a small, single cost category and the chosen totex cost drivers. It should consider whether a single cost category has a relationship with the totex cost drivers when it is pooled with similar cost categories that share cost trade-offs.

434. It also should not exclude a cost category simply because there is a substantial change in the nature of the activity being undertaken. In the first instance, Ofgem should use the model specification to control for changes over time. The regression techniques used are sophisticated enough to control for step changes in costs. Or if the change is at a licensee level, it could make use of a company specific adjustment if the category meets those criteria.

435. We believe the following criteria would uphold a high bar for exclusions:

   a. The cost is entirely exogenous and outside of company control.

   b. It cannot be explained by the cost drivers in a totex model (including through weaker relationships, such as having at least some correlation with scale) and does not share trade-offs with other cost categories.

   c. The cost item must be well defined in the reporting and reported consistently to ensure clean removal.

GDQ56. What are your views on the modelling treatment of workload adjustments for RIIO-GD3?

436. Ofgem's RIIO-GD2 workload adjustments to disallow volumes it deemed to be unjustified as pre-modelling adjustments was unnecessary.

437. The removal of volumes through the volumetric cost driver and associated costs is not needed prior to running a totex regression. Ofgem should let the regression deem costs inefficient – rather than trying to do some of the work for itself and consequently manipulating the totex results.

GDQ57. What are your views on the approach to regional factors for RIIO-GD3?

438. Ofgem is right to look into controlling for regional factors within-modelling where it can, letting the data speak for itself. Pre-modelling adjustments have a serious shortcoming: if the data used to specify the adjustment is flawed, these flaws will be directly translated into the modelling outcomes. At least where flawed data is incorporated in a regression, the modelling results and diagnostic tests can control for this.

439. We would advise that Ofgem investigates the need for regional and company specific factor adjustments at all – this would combat the incentive to for companies to overexaggerate these factors in their submissions. Companies should be required to submit the costs associated with both regional and company specific factors, and Ofgem should investigate whether the factors are correlated with the cost drivers used in the modelling. If there is evidence of correlation, the cost drivers will control for the costs associated with the regional and company specific factors, and therefore further adjustments will not be required in these cases.

GDQ58. What are your views on the approach to company-specific factors for RIIO-GD3?

440. We support Ofgem's criteria for allowing company specific adjustment requests. They set a high bar and will ensure that costs that should be subject to comparative benchmarking remain within totex.

441. As per our response to GDQ57, we would add one more criterion: costs associated with the company specific request should not be correlated with the totex cost drivers to avoid double funding.

GDQ59. In your view, which cost areas will require separate technical assessment in RIIO-GD3?

442. Only costs that meet the totex exclusions criteria and do not lend themselves to comparative benchmarking should be technically assessed.

GDQ60. What are your views on alternative technical assessment approaches for RIIO-GD3?

443. The assessment method is likely to vary across cost categories and depend on the number of companies that incur them. We would rank assessment methods as follows:

    a. In the first instance, Ofgem should use regression analysis to assess efficiency at the total cost level; albeit this method is unlikely to be robust for costs that require separate assessment.

    b. If this is not possible, then turn to ratio analysis. This allows Ofgem to assess efficiencies across both units and volumes together.

    c. If this is not possible, then turn to separate unit cost and volume assessment. This should only be used where there is no relevant driver to explain the costs, as separating the submitted costs and volumes breaks the efficiency assessment down and can undermine overall totex incentives (as companies can be penalised for incurring higher unit costs on a more tightly targeted volume of activity).

    d. If none of the above are possible, use qualitative expert review. This is likely to be required alongside the above assessment methods for cost items where it is critical that allowances are high enough to meet external standards.

GDQ61. In your view, which cost areas will require separate non-regression analysis and benchmarking in RIIO-GD3?

444. Ofgem and gas distributors are best placed to assess this as it depends on the sector specific data.

GDQ62. Which separately assessed cost activities from RIIO-GD2 could potentially be included in totex benchmarking in RIIO-GD3?

445. Ofgem and gas distributors are best placed to assess this as it depends on the sector specific data.

GDQ63. What are your views on retaining the RIIO-GD2 pass-through cost items for RIIO-GD3?

446. Ofgem is right to fund costs that are completely outside of company control via pass-through, as companies cannot find efficiencies here.

GDQ64. What are your views on suitable approaches to the disaggregation of totex allowances for RIIO-GD3?

447. Ofgem should ensure that any disaggregation of allowances takes into account the cost assessment and associated funding mechanisms.

Proposals for Business Plan Data Templates (BPDTs)

GDQ65. In your view what are the high-priority areas of reporting inconsistency between GDNs within the RIIO-GD2 BPDTs and RRPs, and how can these be addressed for RIIO-GD3?

448. Without working knowledge of the current disaggregated reporting, and sight of comparative analysis for GDNs, we are not in position to provide any specific views on this.

GDQ66. We invite views on current reporting requirements and reporting structure at the cost activity level and how this may be adapted to better suit RIIO-GD3 and related development of BPDTs.

449. We support the routine capture of consistent data, that is developed to increase consistency through annual RIGs processes. There is value in maintaining a consistent reporting structure which is able to reliably utilise historical cost data.

450. Where new reporting requirements are introduced, they should be developed with clear and concise guidance and definitions and gas distributors should have the relevant input in the development stage. This will help to ensure new requirements are approached on a consistent basis with transparency of the regulatory intent.

451. Where costs are to be separately assessed these cost categories should be structured in a way that interaction with other tables is limited, to mitigate the risk of double assessment.

GT Annex

452. We have given principle-based feedback on uncertainty mechanisms, outputs and incentives in our executive summary and in response to the Managing Uncertainty section of the overview document.

453. The specific choice and design of the sector specific mechanisms is best explored by Ofgem and gas transmission network companies with a sector specific understanding – but we have provided our perspectives as an electricity distributor network below, where we think they may be relevant.

Secure and resilient supplies

GTQ14. Do you have any views on the effectiveness of this PCD?

454. We agree that work ensuring the protection of, and safe access to, operational network assets will remain important in RIIO-GT3 as it was in RIIO-GT2. As this work is not covered by NARM, we note that Ofgem is minded to retain the PCD that was in place for RIIO-GT2 recognising the need to assess the benefits delivered by this PCD alongside any alterations to the scope and operation of NARM.

455. NARM enables a regulatory output to be established that measures the effectiveness of a licensee's asset replacement refurbishment expenditure (for asset categories within scope), by measuring the improvement in condition based asset risk delivered through these expenditure areas and articulated on a consistent basis. Interventions, and therefore risk, can be traded between asset categories to ensure that customers continue to get best value from the investments that network companies plan to implement in their networks.

456. The underlying principles of NARM outlined above must be protected and a PCD does not offer the same level of flexibility that network companies need respond as new issues and requirements emerge.

457. Under investment in non NARM areas would have consequential impact on reliability and availability metrics with or without a PCD.

Customer satisfaction and Stakeholder satisfaction surveys

GTQ17. Do you have any views on our options for the Customer Satisfaction Survey Incentive? In particular, do you see merit in recalibrating target performance to NGT's most recent performance?

458. To maintain consistency across the industry as well as the drive to improve customer satisfaction, we can see merit in the recalibrating performance to focus National Grid Transmission (NGT) on performing to an even higher level.

459. Ofgem should however recognise that as customer satisfaction scores increase it can be difficult to maintain the progress seen to date and performance may plateau.

GTQ18. Do you have any ideas how the strength of the incentive and the range between capped and collared outcomes should be set?

460. The cap and collar should be symmetrical to incentivise strong performance but also future proof for any drop in performance.

461. There does appear to be some differences in performance by service line. Consideration should be given to developing targets and a possible weighting mechanism to drive greater improvements in those services where performance is lower. In doing so, Ofgem should be mindful of statistical accuracy to ensure low numbers don't heavily impact the overall score.

GTQ19. Which new touchpoint areas could be added to the incentive, and which new engagement and survey channels could be introduced to help NGT improve in the delivery of its services to customers?

462. Consideration should be given to all survey channels, whilst recognising some may have low response rates and a large differential. Trials of this approach would help to determine the best channels to survey via and flag any significant variances in scores by channel.

GTQ20. Do you have any views related to the transparency of the customer survey results?

463. We agree that these should be fully transparent.

GTQ22. What are your views on our proposal to remove the Stakeholder Satisfaction Survey reputational incentive?

464. We agree with the proposal to remove the Stakeholder Satisfaction Survey reputational incentive. We believe that broad brush incentives, not linked to specific services or functions can be difficult to accurately measure and respond to as demonstrated in RIIO-GT2.

Cost of service

GTQ33. Do you agree with our proposed approach to cost categorisation?

465. Ofgem should consider the benefits of further granularisation of cost categories against the resource burden and potential damage to the incentive properties of the overall regime. It should ensure that any changes to the RIIO-GT2 cost assessment are not regressive.

GTQ34. What are your views on setting allowances for internal costs and SO rewards and penalties from the ODIs?

466. Ofgem should be mindful that separate incentives for the System Operator do not distort activity towards visible Gas System Operator outcomes, even if these are not cost effective, and away from more subtle approaches that deliver bigger consumer benefits.

GTQ35. Do you support the need for greater granularity and transparency in cost reporting and to better understand the relationship between GTO and GSO costs to further develop our cost assessment capability?

467. Transparency is essential when assessing costs of this nature, the guidance and associated definitions need to be clear and robust enough to ensure that the right costs are assessed within the right setting.

GTQ36. Is the proposed toolkit appropriate or are there other assessment techniques that we should consider for RIIO-GT3?

468. This toolkit is sensible for a sector where there is only one company. Ofgem should ensure that any cross-sector benchmarking controls for any differences there may be across sectors and does not reduce the robustness of the cost assessment of the larger sector.

GTQ37. Do you have any views on the UMs needed for RIIO-GT3?

469. Ofgem and NGT are best placed to design these sector specific uncertainty mechanisms. Our principle-based positions on uncertainty mechanisms are set out in our response to the Managing Uncertainty section.

GTQ38. Do you have any views on current reporting requirements and structure at the cost category level and how this may be adapted to better suit RIIO-GT3 and related development of BPDTs?

470. NGT is best placed to comment on this, but in principle we support the routine capture of consistent data, that is developed to increase consistency through annual RIGs processes. Where

costs are to be separately assessed these cost categories should be structured in a way that the interaction with other tables is limited, which mitigates the risk of double assessment.