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Dear Hannah

RPI-X@20: Principles, Process and Issues

I have pleasure in providing NGN's response to your consultation. Please note that our response is focussed on gas distribution and the solution for electricity or transmission may be different.

Overall we welcome the consultative process and the overarching guiding principles, particularly no surprises, no retrospective action and no stranding of efficient investment. NGN is keen to be fully engaged in the project and plans to be an active participant in working groups.

The attached response addresses each of the specific questions in your consultation. Please let me know if you would like any clarification of any aspect of this response. Note that our response can be regarded as non-confidential.

Yours sincerely

Alex Wiseman
Regulation Director

RPI-X@20: Principles, Process and Issues

CHAPTER: One

Question 1: Do you have any comments on the rationale for the review?

NGN agrees with the broad rationale of the review as good housekeeping. Nevertheless, we would make the following comments:

- We agree that there is substantive uncertainty about some network sectors, but would suggest that gas distribution is fairly stable now that the repex programme has reached a plateau in terms of annual volume replaced.

- However, if substantial amounts of biogas are to be provided directly into GDN networks then this could impact network operation and may lead to additional capex to ensure adequate local capacity and storage.

- Part of the rationale when the review was originally announced was the high premiums being paid for network utilities. However, in retrospect this clearly appears to have been a "bubble" and quoted network utilities are now trading at RAB discounts suggesting that current returns are unattractive to investors.

- We agree that the framework is complex, but it has evolved to incentivise activities that Ofgem and Government want to encourage (eg innovation, sustainability, reducing fuel poverty). Given the complexity of the environment that networks operate in, the complexity of the current regime may be entirely appropriate.

Question 2: Do you agree with the proposed scope of the review?

Yes, the scope appears appropriate and the visionary phase and emerging thinking consultation will allow adequate time for the networks to be involved in the full consultative process.

Question 3: Do you think the proposed themes for RPI-X@20 are appropriate?

The themes of consumers' needs and sustainability are appropriate. However, as discussed later, the most appropriate ex ante solution to delivering a sustainable energy sector may result in stranded assets. If there is not some reward for risking asset stranding then networks may not deliver the climate change targets and security of supply required.

Question 4: Do you have any views on the proposed approach for engaging with stakeholders?

Full engagement with stakeholders is essential to ensure that all views are heard and considered, although it was disappointing that there was no independent gas distribution network invited to the strawman workshop. Ofgem's approach should enable this to be effective.

Question 5: Do you have any comments on the timetable for the review?

The time allowed for the review is perhaps longer than we believe is necessary as it will be a period of uncertainty for networks. Nevertheless, we welcome the opportunity that this will provide for consultation and stakeholder engagement.

CHAPTER: Two

Question 1: Do you have any views on our aims for RPI-X@20?

We agree with the aims of the review, ie to encourage sustainability, appropriate investment, increasing efficiency, innovation and service quality, and responding to customer needs. As such, appropriate incentives for each aim will need to be set to ensure that networks deliver these outputs and to align Ofgem and wider Government objectives with those of the networks.

Question 2: Do you think the principles for undertaking the review are appropriate and sufficient?

NGN welcomes all the guiding principles and believes them to be appropriate, in particular no stranding of efficient investment, no retrospective action and no surprises. The list appears sufficient to us.

Question 3: Do you have any views on our proposed approach to the review?

Consideration of a wide range of sources is important. Although the review covers all networks, there are differences between gas and electricity and between transmission and distribution. It is important that views for each of these are considered and that solutions for one type of network are not unnecessarily or inappropriately imposed on another.

Question 4: Do you have any comments on the inter-relationships between RPI-X@20, other Ofgem projects and EU and national policy developments?

It is important that there is consistency between this project and the other Ofgem projects and the proposed cross-project working is essential to ensure no mismatch in outputs.

CHAPTER: Three

Question 1: Are the original principles of RPI-X regulation still valid?

RPI-X has clearly evolved substantially since the original Littlechild model. However, the original concept of a model that delivers efficiency savings remains and has proven effective. The evolution has been both necessary and appropriate to ensure that networks deliver Government and Ofgem objectives to ensure the best solutions for customers.

RPI-X regulation provides a stronger incentive to deliver efficiencies than the “rate of return” regulation used in America, and the evolution of additional incentive measures has ensured improvement in areas such as customer service, innovation and sustainability. Consequently we believe that RPI-X remains a valid and appropriate way to regulate networks.

Question 2: Do you have any comments on our description of the context of energy regulation since privatisation? Are there any issues or events relevant to the regulation of energy networks that we have not considered??

NGN broadly agrees with the context although it should be noted that, while measures to tackle climate change are likely to have a profound impact on the size and shape of future electricity networks, the impact on gas distribution networks will be much more limited.

We agree that the financial markets are currently much more challenging as may be expected in a cyclical capitalist economy. However, the economic climate has deteriorated to a much greater level than in previous economic cycles. The allowed cost of capital needs to recognise that markets at times are disrupted and that historical capital costs and availability of finance

are not always a guide to the future. The current high cost of debt reflects a market correction that needs to be addressed in future cost of capital allowances.

Question 3: Do you have any comments on our description of the evolution of network regulation since privatisation?

We have no comments.

Question 4: Do you think our description of the existing regulatory framework in electricity and gas transmission and distribution is the appropriate base case (starting point) for RPI-X@20? Is it appropriate for us to consider electricity distribution regulation using developing proposals from DPCR5?

RPI-X has evolved in a sensible and structured manner and consequently we believe the existing regulatory framework is the appropriate starting point for this review.

We have no comments on DPCR5 and electricity distribution regulation – this is a matter for electricity DNOs to assess.

Question 5: What lessons do you think RPI-X@20 can take from the history of energy regulation?

The main lesson is the success of the regulatory regime to date with allowed revenues reduced by 30-60% at a time when quality of service has improved.

Question 6: Do you have any comments on our assessment of the performance of the network industries since privatisation?

Ofgem comments on actual returns being higher than allowed returns, but it is entirely appropriate and essential that efficient companies delivering real service improvements, as well as sustainability and innovation, benefit from incentives designed to achieve increases in efficiency above target and improvements in customer service.

Question 7: Do you think our description of energy networks and the regulatory framework today (the legacy of RPI-X) is accurate? What do you think the implications of this legacy are for RPI-X@20?

Our comments on Ofgem's consensus view on energy network companies, focussing on GDNs, are as follows in the same order as Ofgem's list:

- We agree that the efficiencies achieved have led to a tight operating base which limits networks' ability to take on new challenges or to cut costs further. Many networks cannot now cut costs further without impacting customer service or increasing risk to delivery.
- The challenge of the tough settlement for GDNs on cost of capital – below that of other network industries and well below the current cost of capital – is increasing the pressure to increase gearing across our industry.
- The allowed cost of capital indeed drives companies to be low risk. However, this does not necessarily mean risk averse. Although we would certainly want to avoid risks that we cannot control (such as exposure to gas prices when purchasing shrinkage gas), we would be willing to take on additional risks for additional, commensurate, allowed returns.
- It is certainly true that networks are only willing to undertake investment when commitment is provided by users and/or it will be allowed in RAB as networks are not rewarded for investing in speculative assets. This may need to change to deliver the sustainable energy networks required.

- GDNs are investing considerable effort in developing their structure of charges to continue to ensure that they are fully cost reflective.
- Customer service is a key driver for NGN – our vision is to be in the top two GDNs for customer service, safety and efficiency, and customer service is discussed at each senior management meeting and Board. For example, we raised the proposal of a balanced scorecard approach to customer service with Ofgem two years ago as a way of developing a "league table" of GDNs and monitoring performance. NGN would welcome an extension of benchmarking to customer service.
- It is probably fair to say that we are reactive to Government policy, we are too small to significantly influence it. However, the larger players such as National Grid are most certainly pro-active in efforts to influence Government policy.
- The innovation incentive has certainly changed behaviours and has successfully encouraged network innovation.
- Security of supply and shrinkage gas costs are critically important to NGN and consequently we do focus on both gas brought onshore and wholesale gas prices. Furthermore retail gas prices affect demand which necessitates management focus. Shipper and supplier relationships are important to NGN as is our relationship with the NTS and we have regular meetings with these bodies and other industry participants.

The overall impacts of this legacy are:

- Incentives are required to ensure the appropriate behaviours. However, most networks will exercise a degree of corporate social responsibility to ensure that their activities and conduct are appropriate; certainly NGN takes it CSR responsibilities very seriously.
- There needs to be recognition that there is only a finite scope to efficiency reductions and further efficiency pressures will lead to less rather than greater focus on the industry as a whole.
- Risk and reward are linked and networks can only be incentivised to take greater risks by the potential for higher rewards.

Question 8: Are the identified challenges the right ones? Are they new challenges not previously addressed? Are they short-term (temporary) or permanent challenges? Are there others that we should consider in RPI-X@20?

Undoubtedly energy networks, particularly electricity, are changing more rapidly than in the past in order to deliver a sustainable energy sector. However, NGN believes that the broad RPI-X framework will be able to cope adequately with this challenge.

We agree that the current turbulence in financial markets creates uncertainty on financeability and significant upward shift in the cost of raising long-term finance.

It is not clear to us that there are any specific challenges on charging level and variability for gas networks; the main issue causing variability of charges is the impact of gas prices on the requirement to purchase shrinkage gas (compared to electricity DNOs which are incentivised to reduce losses but don't need to purchase electricity).

An additional challenge for gas distribution networks is the shift from a low-risk utility with regulated, defined income to one that has to make substantive commercial decisions on interruption contracts and exit charging or alternatives to procuring exit capacity.

CHAPTER: Four

Question 1: We present a number of issues that we will consider when assessing the processes that we and networks use to focus on consumers. Have you any views on these issues? Are there others that we should also consider?

Customers: We believe that we are focussed on final energy consumers or their customers. As mentioned we would welcome an incentivised balanced scorecard approach to ensure that all networks focus on the needs of customers.

Network charges: GDNs have invested considerable effort in fulfilling their licence obligation to ensure that the structure of charges is cost reflective. We would be pleased to assist the fuel poor and vulnerable customers but it would need a licence change for us to allow cross-subsidies to help these customers. The level of network charges directly reflects allowed revenue.

Balancing of different objectives: We fully agree that there needs to be a balance of factors such as charges, reliability and delivery of security of supply, environmental and social objectives. We provide detailed information, in particular through the cost reporting and quality of service submissions, and we believe that Ofgem is best placed to determine this balance for gas distribution networks and not customers.

Regulatory complexity: The regime is complicated, but the complexity is, in our view, necessary given the complex environment in which we operate. To deliver Government and regulatory objectives on sustainability, health & safety, environment, fuel poverty, customer service, vulnerable customers, security of supply and other key areas requires a raft of incentives that of necessity leads to complexity. However, we fully agree that a way needs to be found of communicating the key components to customers. GDNs have in particular successfully engaged with shippers to explain current and forecast charges. The "mod 186" report, which provides five year forecasts of the components of allowed revenue and hence of shipper charges has been well received and could be rolled out to other network sectors to improve the understanding of charges.

Consumer engagement: Ofgem asks whether consumers should be more directly involved with the regulatory process? It is appropriate that there is greater consumer engagement, and the process used within DPCR5 may be a useful model to use to ensure communication of, and input into, business plans. However, as indicated above, the regulatory process is, of necessity complex and we believe that the role of Ofgem is to act on behalf of consumers and to ensure that they are adequately represented by Ofgem.

Legitimising the regulatory process: We do not believe that consumers or their representatives should have a right to appeal the settlement. Otherwise, for example, it may be the case that all settlements are appealed. However, it is legitimate and appropriate that consumers should have full access to the regulator to ensure that their views are represented in the final settlement.

Question 2: We present a number of issues that we consider when assessing how the regulatory framework encourages networks to meet the needs of consumers. Have you any views on these issues? Are there others that we should also consider?

We agree with the issues that Ofgem presents. However, at times, Ofgem may need to represent the "intelligent customer" as customers will not always be able to articulate future requirements. Ofgem will also need to choose between opposing views and priorities.

Question 3: Are the issues different for gas and electricity, and for transmission and distribution?

Engagement with customers and assessing requirements five or more years away makes more sense for transmission than distribution and the report by Littlechild and Cornwall focuses on engagement in electricity transmission. Direct constructive engagement is probably least suited to gas distribution.

CHAPTER: Five

Question 1: Do you have any views on our description of the sustainability challenges facing networks? Are these new challenges? Are the challenges different for electricity and gas, and for transmission and distribution?

We agree with Ofgem's description of the sustainability challenge. There is certainly a difference between gas and electricity. Electricity is facing rapid and considerable changes with the linking up of new renewable sources and, potentially, local generation schemes. Furthermore, there is a genuine dichotomy on the long term nature of the electricity network – whether it is "big" transmission and distribution or whether there are "micro-grids".

The main medium term impact on GDNs is the likely increase in biogas injected into the network which may lead to local reinforcement requirements to transport this gas to where the need is and additional compression requirements.

Question 2: We present issues that we think we should consider when assessing how decisions about what needs to be done by the networks are incorporated in the regulatory regime. Have you any views on the list of issues? Are there others that we should consider?

Our views on the list of issues are as follows:

- A new challenge. For gas distribution, we believe that changes are incremental and hence do not lead to a requirement to change regulatory processes at this stage.
- Proactive networks. Strategic decisions about the role of networks should be made by Government and regulators and not by networks. However, networks can and should contribute to the debate and engage with Government and Ofgem.
- Degree of regulatory intervention. Networks need guidance to determine what is needed to deliver a sustainable energy sector. For example, it is for Government to define the steps required to achieve the 80% carbon reduction target in 2050. It is not for networks, independently, to assess requirements; indeed it would be dangerous for them to do so with a risk of either non-delivery or delivery of over capacity. Sometimes third parties will define targets, for example the GDN repex programme has been agreed with the HSE, but it is essential that regulators are involved in these decisions to determine that they deliver value for money and to ensure that appropriate incentives are used to achieve required outputs.
- Investment requirements. PAS 55 will help to ensure that networks understand the condition and capacity of their asset base and can make informed decisions about new investment or improved use of the existing network. However, it is for Ofgem and Government, through appropriate incentive mechanisms, to ensure the appropriate balance between security of supply, environmental targets and the social agenda.
- Keeping options open. Our decisions tend not to close down options. A decision not to invest still leaves the option to invest open. A decision to invest now may, however, in hindsight prove unnecessary or too early if demand is lower than anticipated. Networks should not be penalised retrospectively for decisions which were based on the available information and forecasts at the time.
- Supply chain interactions. Our investment decisions are based on our long term statement which is derived from demand forecasts based on econometric data. We welcome feedback from other parties in the supply chain but we believe our forecasting methodology provides a robust basis for investment decisions. We do have considerable interaction with the NTS to ensure consistency and to understand any forecasting differences, which may be due to local factors.

Question 3: We present issues that we think we should consider when assessing how the regulatory framework can ensure that any capital investment is efficient and is financed. Have you any views on the list of issues? Are there any others we should consider?

We consider each of the issues raised in turn:

- Comparison with other investments. There does not appear to be any need to treat environment related investment differently. Providing it is approved by Ofgem (and efficient) it should enter the RAB like any other investment.
- Investment plans. Determining the investment required is fairly straightforward for GDNs and is based on the forecasts underpinning the long term statement. A ten year statement is an appropriate timeframe with firmer investment plans in the first 5 years. Ofgem, appropriately, reviews projects on an individual basis and then sets a total capex plan. We believe that the "strong capex roller" currently in place is the most appropriate incentive. It enables GDNs to adjust capex plans within an overall target as the environment changes during the price review period whilst still incentivising efficiencies that benefit both customers and shareholders. The challenge process by Ofgem, together with its consultants, during the price control enables appropriate capex targets to be set.
- Anticipatory investment. For some networks, but less so for GDNs, anticipatory investment should be encouraged. If Ofgem is not minded to automatically allow this into the RAB and requires networks to take demand risk (with potential asset stranding) then a much higher cost of capital must be allowed to reward the risk taken.
- Delivery of investment. It should be for networks and not for Ofgem to determine whether the network delivers the investment or whether the network chooses to contract it out. If a network makes inefficient decisions then it can be penalised at the next price control by using the benchmark of the network with the lowest unit costs.
- Funding network investment. We have no opinion as to whether subsidies for new technology should be paid for by customers or Government. However, we do believe that tariffs should continue to be cost reflective. Hence if Government wishes that different classes of customers pay different amounts then this should not be for networks to implement but for Government to implement in an alternative way, eg via subsidies or taxation. Alternatively, suppliers and shippers are better placed then networks to adjust tariffs between classes of customers.

Question 4: We present issues that we think we should consider when assessing how the regulatory framework balances risks and rewards. Have you any views on the list of issues? Are there others that we should consider?

The list of issues is fairly comprehensive. As discussed earlier, if networks are to take a risk that the full investment does not enter the RAB then a compensating reward, probably via cost of capital, is appropriate. Undoubtedly the sustainability agenda presents more risks to networks because of the uncertainty and also more costs. For example, for GDNs it is unclear how much demand there will be for biogas injections into the networks. Ofgem and the GDNs should work together to assess the impact and potential solutions, however a solution appears possible within the existing framework, for example a solution similar to the electricity DNO RPZ scheme which incentivises connection of generation to distribution systems.

It should be noted that in order to achieve the carbon targets, assets will have to be constructed prior to full commitment of energy developers. Hence there is a high risk that, to deliver a sustainable energy network, there will be stranded assets which cannot be foreseen in advance. There needs to be a methodology for compensation for these stranded assets otherwise enabling infrastructure will not be delivered and carbon benefits will be delayed.

There are, potentially, two types of "error" in investment:

- a network fails to invest in capacity that subsequently turns out to be needed; or
- a network invests in capacity that turns out not to be needed.

If the rewards aren't there for taking the second of these risks then networks will underinvest and the first error will occur. The impact may be that Government objectives are missed and consequently Ofgem needs to be mindful of the risks and rewards available for making investment for non-committed capacity.

Question 5: We present issues that we think we should consider when assessing how the regulatory framework can encourage innovation by the networks. Have you any views on the list of issues? Are there others that we should consider?

We have nothing to add to the list of issues. Undoubtedly innovation is important for networks, in particular in a changing world. The IFI appears to be an excellent way to encourage innovation and has delivered many beneficial projects in both electricity and gas.

Question 6: Are we addressing the right issues and questions in the 'Delivering a sustainable energy sector' theme? Are there any issues missing from this theme?

The list of issues and questions appears both comprehensive and appropriate. The challenge will be to answer all these questions and to ensure that appropriate solutions are developed for the four different sectors of electricity and gas, transmission and distribution.

However, there needs to be clarity on the role of networks:
- Are they passive responders to signals from network users?
- Should they anticipate users' requirements?
- Or should they shape users requirements?

Question 7: Are there issues that need to be covered in RPI-X@20 that are not adequately captured by our two themes? Please specify that these issues are.

We have no further issues to add.

CHAPTER: Six

Question 1: We have presented a number of ideas on changes that could be made to the existing regulatory framework. Are there other alternative frameworks that you think RPI-X@20 should look at?

We believe that the current regulatory regime is one of the most effective in the world and we do not consider that there are any further frameworks that should be considered.

Question 2: Do you have any provisional views on any of the ideas presented here?

- Customer participation. Constructive engagement may work in transmission but it is difficult to see its applicability to GDNs.
- Guiding mind. We agree that a "guiding mind" approach would be helpful with clear guidance on objectives from Government or Government bodies to enable Ofgem and networks to appropriately target incentives and focus resources. This has worked well in gas distribution for the repex programme whereby the HSE has set the overall target and Ofgem worked with gas distribution to determine the costing, the remuneration process and the incentives for over and under performance.
- Output monitoring. The opportunity will vary for different sectors. The gas distribution primary output is delivering a network that can cope with a 1:20 winter. This is

primarily by investment as demand increases but innovation in changing ways of working can also help to deliver increased capacity.

- The role of networks and the system operator. This is primarily an issue for transmission; we do not see the benefits of any change to the role for GDNs.
- Tendering. The efficiency of network procurement measures can be assessed via the cost reporting and price review benchmarking. An efficient procurer will be rewarded and an inefficient procurer will have tougher efficiency targets that may mean it has to adopt a new business model. The benefit of gas network sales can be seen in the variety of business models of the four owners from a fully outsourced operation (NGN) through to bringing much of the contracting for construction in-house (Scotia). We do not believe there is any requirement for tendering to be imposed as the current regulatory model provides strong incentives for companies to move towards more optimal arrangements. It is certainly not clear that tendering would be the appropriate and most efficient model for each network owner.
- Franchising. We have similar comments to those for tendering.
- Capacity auctions. The existing auctions for interruption rights appear not to work efficiently as market power is often held by the only large user in an area with a capacity restraint. Consequently this user can successfully bid up to the annualised cost of reinforcement which may bear no relation to the cost to the user of interruption. Similarly, we do not see capacity auctions working effectively in gas distribution as there is often only a single bidder at any one offtake; this may be an area to revisit within the review.
- Deregulation. We do not think that further deregulation would be effective. Indeed, we have concerns that the existing IGTs do not currently operate on a level playing field with GDNs and that customers of IGTs get a lower quality of service than those connected to GDNs.
- Ex-post regulation. This presents a high degree of risk to networks with a danger of disallowance of investment. We believe this would stifle innovation and risk-taking. The current "strong capex roller" provides strong incentives on companies without stifling their ability or incentive to innovate. Furthermore, customers benefit by around two-thirds of the value of any outperformance.
- Rate-of-return regulation. In our view this reduces the incentives for efficiency and could inappropriately provide an incentive for gold-plating investment.

CHAPTER: Seven

Question 1: Do you have any views on the proposed next steps for the review?

The next steps, with industry engagement and full consultation as options are narrowed, is appropriate. We look forward to engaging with Ofgem by actively participating in the workgroups and in future consultations.