Consumer Focus
Campaigning for a fair deal

Consumer Focus response to Ofgem's consultation *Strategy for the next gas distribution price control – RIIO-GD1 and Transmission Price Control – RIIO-TD1*

February 2011

We welcome the opportunity to comment on Ofgem's consultation on strategy for the next gas distribution price control – RIIO-GD1 and the transmission price control RIIO-T1.

Consumer Focus is the independent champion for consumers across England, Wales, Scotland, and for postal consumers in Northern Ireland. We operate across the whole of the economy, persuading businesses and public services to put consumers at the heart of what they do.

Our comments on Ofgem's consultation are made from the perspective of our experience of championing consumers' interests in private and public sectors. We have a particular focus on the interests of consumers in markets such as energy that are 'designated' by Government as requiring additional consumer advocacy. We work to secure fairer markets, greater value for money and improved customer service. We have a commitment to work on behalf of vulnerable and disadvantaged consumers, and a duty to work on issues of sustainable development.

Executive summary

Consumer Focus believes that Ofgem has made a good start in its attempts to conclude a regulatory settlement which provides consumers with value for money. There are many proposals in the numerous annexes which we hope that Ofgem will confirm in its strategy decision document in March 2011. There are however some issues where we would welcome clarification from Ofgem. There are also areas where we disagree with Ofgem and have put forward arguments which we hope they will consider, and ultimately accept. We have responded to the numerous consultation questions where we feel we can provide Ofgem and other stakeholders with valuable input. Our answers are contained below.

We have also provided a summary of the main issues raised in our consultation response. These are split into proposals we support, those we do not support and any alternatives we could support instead. We have ordered our views in the below table in the order we raise them in our consultation response.

Support	Do not support	Alternative
Development of additional uncertainty mechanisms which reduce the potential volatility of network charges.		
To reduce the maximum level of consumer funding for innovation stimuli projects to 80 per cent.		
To fully capitalise repex.		
The network companies must justify the need for any transitional arrangements as a result of the full capitalisation of repex or changes to asset lives and resulting cash flows.		
Cost of debt indexation in principle.	A separate allowance for the costs of issuing debt.	

Support	Do not support	Alternative
	Ofgem's approach to calculating the range for the cost of equity.	Europe Economics proposed range for the cost of equity would seem more robust.
	The upper range of equity risk premium suggested by Ofgem does not seem to be justified.	
Benchmarking of efficient pension costs should include non network company comparators. Retained pension surpluses should be returned to consumers.		
The introduction of independent auditing in regulatory reporting.		
A financial penalty for poor complaints handling performance in conjunction with the guaranteed standards.		
	The financial reward for stakeholder engagement.	A symmetrical reward/penalty for stakeholder engagement. A reduction in the size of the financial incentive.
The continuation and proposed review of the network extension scheme.		
The removal of the caps on fines for the guaranteed standards of performance and guaranteed standard for supply restoration.		
The change to the repex revenue driver from length of main decommissioned to a volume driver of risk removed.		
A symmetrical financial incentive for the output on network reliability.		

Support	Do not support	Alternative
The network companies must justify the need for changes to revenue profiling.		
Broadly support proportionate treatment process but Ofgem must err on the side of caution in its decision making.		
Ofgem must err on side of caution in any decisions it makes on fast tracking.		
	Do not believe the case has been made for an additional reward for superior network companies.	
The innovation stimuli should apply to projects which facilitate a low carbon energy sector and long term value for money.		
	Innovation stimuli funding should not be completely funded through fast money.	Funding should be made through the standard expenditure capitalisation ratio.
A limited innovation allowance should be set on an output basis. The value of the allowance should also be potentially lowered.		
The loss of meter work revenue driver should be removed.		
		Ofgem should reconsider the use of quantitative thresholds for the mid-period review.
The assets lives proposed for gas and electricity transmission and distribution.	A front loaded depreciation profile for new gas distribution investment.	A straight line depreciation profile should be adopted.
The tax benefit of excess gearing clawback and timing of true adjustments for existing controls should be spread over eight years.		

Support	Do not support	Alternative
	A primary output with reward attached for RIIO-T1 on Transmission companies' contribution to the UK's environmental objectives.	If there is any output with a financial incentive it must be symmetrical (reward and penalty).

Response to consultation questions

RIIO-GD1 Overview paper

CHAPTER: Three

Question 1: Do you have any comments of the overall approach to stakeholder engagement?

Question 2: Do you have any views on how our engagement process and that of the network companies could be made more effective?

Consumer Focus thinks that the stakeholder engagement process has worked fairly well up until now. The real test of whether the greater emphasis on stakeholder engagement has been a success or not will be in how the Gas Distribution Networks (GDNs) incorporate stakeholder views and feedback into their business plans and the outputs they wish to deliver.

In future it may be helpful to stagger the transmission and distribution price controls so that the engagement processes for both are not taking place simultaneously. This may make it easier for stakeholders with fewer resources to engage, and improve the richness of the feedback that they can give to the networks. On a broader point, staggering the timing of price controls may also allow Ofgem to learn from experience more quickly (ie not have to wait eight years before any transferable learning can be applied).

CHAPTER: Five

Question 4: Do you have any views on the proposed role for competition in third party delivery?

We recognise the benefits that fostering competition in the delivery of monopoly network services can provide consumers. However, Ofgem must be certain that the existing network infrastructure will not be compromised before it makes any decision on the involvement of third parties in the delivery of network services.

CHAPTER: Six

Question 2: Question 2: Are there any additional uncertainty mechanisms required that we have not identified?

We believe that Ofgem should give further thought to introducing uncertainty mechanisms which reduce the potential volatility of network charges. We are aware of research undertaken by CEPA for Centrica which estimates that a supplier might have to charge an additional risk premium of 5.5-6.5 per cent into its forecast gas distribution costs over the price control period to effectively manage risk. Measures which can reduce this risk premia (such as 'logging up' or caps and collars) should be given the utmost consideration by Ofgem. While such measures might have impacts on networks' financeability and cost of capital, we believe the potential savings for customers are significant and require thorough analysis.

CHAPTER: Seven

Question 2: Do you have any views on the time limited innovation stimulus?

We support the proposal to decrease the maximum level of consumer funding for projects submitted under the innovation stimuli from 90 per cent (as is the case under the Low Carbon Network Fund or LCNF) to 80 per cent (there might even be case for lowering the percentage further). We believe that this change will provide greater incentives on companies to undertake projects efficiently with associated benefits for consumers in terms of better value for money. We are of the view that this rebalancing of risk sharing between shareholders and consumers will not undermine the level of interest in innovation stimuli funding or the incentives on network companies to think and act more innovatively. We think the sheer weight of proposals submitted under the LCNF supports this view.

CHAPTER: Eight

Question 2: Do you have any views on our proposed approach to capitalisation and depreciation policies?

We completely agree with Ofgem's proposal to fully capitalise repex (which is currently treated as 50 per cent capitalised and 50 per cent opex/fast money). We believe this change will provide consumers with a fairer deal for the required repex (the major element of repex being the iron mains replacement scheme). This will allow a fairer share of funding to be borne between current and future consumers than exists at present. We believe this change is in line with RIIO principles.

Question 3: Do you have any views on our proposed approach to implementing any transitional arrangements required to address cash-flow affects from a change in our repex capitalisation policy?

We believe that any transitional arrangements proposed as a result of the decision to fully capitalise repex needs to be clearly justified as being in the interests of current and future consumers. It is for the network companies to unambiguously demonstrate that a change in the capitalisation policy will cause them insurmountable problems in financing their regulated activities. The interests of current consumers (in terms of the need to provide additional funds to networks as part of any transitional arrangement in the form of higher network charges) must be taken into account in any Ofgem decision. This is particularly important at the current time considering household gas bills are increasing with further increases likely to fund capital investment to meet statutory environment targets.

Question 4: Do you have any views on our preferred approach to assessing the cost of debt?

While we do not have the technical expertise to comment on the precise mechanism for indexing the cost of debt, we would like to make known our support for indexing the cost of debt in principle. We are aware of the concerns the network companies have. They believe cost of debt indexation might make it more difficult for them to finance their regulated activities. The networks also have concerns that the cost of indexation method might be difficult to administer in practice.

It is our view that these claims have yet to be substantiated. In fact it is arguable that cost of debt indexation should remove the risks to networks if the market cost of debt were to increase above a fixed allowed cost of debt. This could potentially reduce a company's cost of capital.

However, the most important point in our opinion is that cost of debt indexation removes the need for 'headroom' in the cost of debt allowance (this headroom has been a feature of regulatory price control determinations. This practice has been applied to ensure against the risk of underinvestment by network companies, which potentially could lead to rationing of services in a worst case scenario for consumers[1]). This saving for consumers must be given the utmost consideration by Ofgem in spite of perceived problems with the particular method of indexation.

Question 5: Do you have any views on our proposed approach to assessing the cost of equity and the associated range of 4.0-7.2 per cent (real post-tax)?

We note the greatly differing ranges proposed by Ofgem and Europe Economics on the initial range for the cost of equity (Ofgem proposes a range between 4 per cent and 7.2 per cent while Europe Economics propose a range between 4.2 per cent and 5.6 per cent). Our understanding of why Europe Economics' cost of equity range is narrower than Ofgem's is because it has applied the rationale contained within the 2003 Smithers Report[2]. This is that the overall market return is more stable than its component parts, in this case, the risk free rate and the equity risk premium (Europe Economics also reference the determination by the Competition Commission (CC) in the Bristol Water judgement).

It is our understanding that Ofgem's range for the cost of equity is wider (particularly at the higher end of the scale) because their range incorporates cost of equity values made in past regulatory determinations. However, we would note that Ofgem states that its past decisions are not always appropriate for setting the components of the allowed return.

We believe that Ofgem needs to communicate to stakeholders the reason for their wider range for the cost of equity. Ofgem is using a different method in comparison with the one used by its own consultants, Europe Economics, who provide a good rationale for the method of determining the range of the cost of equity. We'd also add that the determination technique employed by the CC provides a strong signal of their likely approach to the cost of equity in the event of an appeal. We believe that this provides a strong steer to Ofgem on what their approach should be in setting the cost of equity given that a determination in this range would provide a lower cost outcome for consumers.

We would also note that the upper range of the equity risk premium (ERP) of 5.5 per cent seems not to be supported by evidence or regulatory precedent. For example the CC's Bristol Water decision concluded that a range of 4-5 per cent was appropriate. Furthermore the Bank of England's December report showed a decline in the assumed ERP range to 4-5 per cent over the medium and long term. Ofgem believes that the higher upper bound is justified by economic uncertainty. However, Ofgem's upper bound of 5.5 per cent has only been achieved or exceeded in times of severe economic difficulties in financial markets. Furthermore, our understanding is that the ERP is more likely to be driven by market perceptions of relative risk between asset classes rather than economic uncertainty in itself.

Question 6: Do you have any views on the other elements of our financeability proposals?

We only add here that the benchmarking of pension costs as part of Ofgem's efficiency reviews should include non-network company comparators which operate in competitive markets. This should help ensure that consumers only pay efficient pension costs.

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[1] See **http://bit.ly/hlln5n** for a fuller discussion of the benefits of indexing both the cost of debt and equity as well as 'headroom'.

[2] Wright, S., Mason, R., and D Miles, (2003), *A Study into Certain Aspects of the Cost of Capital for Regulated Utilities in the UK.*, A paper on behalf of Smithers&Co.

Furthermore any retained pension surpluses should be returned on at least an equivalent basis to consumers, considering that consumers will have funded current and previous deficits.

Annex: Outputs and incentives

CHAPTER: One

Question 4: Should we introduce an independent examiner for all companies to improve regulatory reporting?

Consumer Focus completely agrees with this proposal. We support the use of independent auditors to ensure the quality of data provision related to output and cost data. We also note that there is regulatory precedent for the use of independent auditors in the water and rail industries. The accuracy and reliability of such data is crucial in allowing Ofgem to make a regulatory determination which delivers value for money to consumers. It should provide greater confidence to stakeholders that the network companies are refraining from 'gaming' the regulatory settlement. We would note the case of National Grid being fined by Ofgem for reporting inaccurate information, including double claims for work on mains pipes[3]. Such incidents do nothing to maintain stakeholder confidence in the integrity of data reporting from utilities.

CHAPTER: Two

Question 1: Do you agree with our proposal to require GDNs to report the capacity of bio-methane connected as a broad measure of environmental impact but not to adopt an associated financial reward/penalty?

We broadly agree with this proposal. Furthermore, we agree that the output is not sufficiently within the control of the GDNs to warrant a financial incentive. The potential for windfall gains or losses would represent poor value for money for existing and future consumers.

Question 2: Is there any other measure of environmental impact which you believe could be financially incentivised, bearing in mind the need for an output to be measurable and controllable by the GDNs?

To our knowledge there are no further suitable environmental outputs which we believe could be financially incentivised. We would reiterate that for any output to be financially incentivised must be accurately and reliably measureable and within the network company's control to a sensible degree to ensure value for money.

Question 4: Are there any wider-network benefits associated with bio-methane which might imply that we need to change the current connection charging boundary?

We suspect that many potential bio-methane sources will be relatively close to centres of population, given that landfill waste and sewage are fuel sources. As such, development of bio-methane might require less network investment when compared with connecting more remote fuel sources. This may justify lower connection charges than more remote gas entry points, although we do not have a strong view on whether changing the connection charging boundary is necessary to achieve this. The key point here though is that the principal consumer benefit comes from proximity to demand, not from the technological source of the energy.

[3] **http://bit.ly/g2M1KT**

On a secondary level, development of bio-methane should assist security of supply through diversifying gas entry points on to the networks.

Question 5: We would welcome respondents' views on our proposed approach not to recover connection and downstream asset costs through general network charges. In particular, we would like to hear views on the potential rationale for socialising the costs of connecting bio-methane plant, and how we might be able to do this within our vires.

Consumer Focus has not yet heard compelling evidence that implementing a cross subsidy in this area is a cost effective way to decarbonise at low cost to consumers. Our preference is to create a level playing among competing energy technologies so that it is the underlying cost of the technology which determines whether it is built, not based on wholly uneconomic public subsidy. We recognise this is difficult to achieve in practice but believe that should be the aim for regulators and policy makers.

Question 6: Do you agree with our proposed approach of logging-up costs associated with bio-methane connections in the event that the connection boundary changes?

Consumer Focus is broadly supportive of this approach. We believe this should help reduce the volatility of network charges and thus reduce the total cost to end users.

Question 9: Do you agree with our proposal to broadly continue with the shrinkage allowance mechanism and Environmental Emissions Incentive (EEI) adopted at GDPCR1?

Consumer Focus agrees with the proposed method as long as the modelling and forecasting can adequately prevent GDNs from earning an excessive rate of return on overly large allowances. Consumer Focus agrees that Ofgem needs to be confident that the allowances it sets for tackling shrinkage is challenging for the network companies and does not incentivise wasteful gas shrinkage investment costs.

Question 11: Should we retain a cap and collar on the EEI and at what level should any cap and collar be set? Should we introduce a cap and collar on the shrinkage incentive mechanism, and if so, at what level should any cap and collar be set?

Consumer Focus believes there is obviously a need to prevent windfall gains and losses due to forecasting uncertainty. However we also recognise that there is a need to provide incentives for the companies to deliver in an efficient manner. As such we recommend a compromise arrangement whereby the caps and collars are retained but the levels of the caps and collars are increased in line with any change to the value of carbon.

Question 13: Do you agree with our proposal to require GDNs to report actual shrinkage data when the relevant data becomes available, with the intention that we will use actual shrinkage as the basis for the shrinkage allowance and EEI at future reviews?

If such a change is practically possible we would support such a move. This is because actual data is by definition more accurate and reliable than forecast data. As such it should allow Ofgem to make better regulatory decisions.

Question 14: Do you agree with our proposals to require GDNs to establish a code of practice outlining how they will identify and process unregistered sites? Do you agree with our proposals to require GDNs to report annually on the number of unregistered sites they have processed?

We believe this is a sensible approach as it shall allow GDNs to understand and tackle the sources of lost gas.

Question 15: Do you agree with our proposal to publish companies' business carbon footprint (BCF) as a league table to provide reputational incentives but not to provide an associated financial penalty/reward?

Question 16: Do you agree with our proposals to publish other emissions and resource use but not to apply financial rewards/penalties?

Consumer Focus agrees with Ofgem that there are already a number of environmental incentives placed on the GDNs. We believe it is in consumers' interest that financial incentives are not duplicated such that consumers effectively pay twice for the same output.

CHAPTER: Three

Question 1: Are there any aspects of customer service provided by the GDNs not captured by the proposed broad measure?

The big six energy suppliers were audited in October 2008 to assess their compliance with the newly introduced complaint handling standards. This has been followed up by an annual complaint handling customer satisfaction survey in 2009 and 2010 to assess the experience of consumers that have contacted their supplier with a complaint. Given that the GDNs compliance with the complaint handling standards has not been audited to date, there is a case to make customers who have specifically raised complaints a specific stratum of the customer satisfaction survey to ensure the consumer experience is monitored.

Question 2: Other than those specified, are there any other customer-GDN contact experiences that should be captured in the customer satisfaction survey?

Consumer Focus suggests that it would be useful to divide the connections group into those customers that obtained a quotation and those that had actually had the work carried out. As detailed under question 1, we believe it would be important to include those customers who had experienced the GDN's complaint handling process.

Question 3: Do you agree with our approach to introduce a financial incentive linked to the successful resolution of complaints?

Consumer Focus believes that the introduction of a financial incentive linked to the successful resolution of complaints will drive improvements in company complaint handling and ultimately deliver a better service to consumers. We believe it is appropriate to have an asymmetric financial incentive (penalty) for complaints. The potential for perverse incentives in implementing a symmetrical incentive (reward and penalty) is quite serious in our opinion. Ofgem should not ideally be looking to financially incentivise good complaint handling when ideally there should be incentives to reduce the quantity of complaints in itself.

However, we do have concerns regarding the consistency of the direct complaints data used in the metric. This is based on our experience with the energy suppliers' data where significant variation in recording practices and definitions exists and is currently under investigation.

We believe that there must be a consistent approach across the GDNs to ensure comparable data is collected and this should be subject to independent audit. We also have concerns regarding the use of Energy Ombudsman cases due to the extremely low case volumes for some GDNs. We would suggest that the data is modelled before a final decision is made on how the different categories will be weighted.

Question 4: Do you agree with our proposal to introduce a measure associated with resolving complaints alongside the existing guaranteed standards?

Consumer Focus agrees that a measure associated with resolving complaints should be introduced alongside the existing guaranteed standards. We believe that the GDNs should demonstrate compliance with the complaint handling standards by collating and reporting on this data. This will also incentivise companies to improve their complaint handing processes through visibility of their relative performance. We support the retention of guaranteed standards as this ensures a direct compensation payment to the customer who has experienced the issue.

Question 5: Should we retain the discretionary reward scheme, given our proposed stakeholder engagement mechanism as part of the broad measure?

Consumer Focus believes the discretionary award scheme (DRS) has proved an effective regulatory tool in both electricity and gas. Consumer Focus and its predecessor body energywatch were involved in judging the schemes since inception and therefore have a close understanding of their merits and shortcomings. We believe the discretionary award scheme has driven improvements across the industry particularly in the recognition of and interactions with vulnerable consumers including successful joint initiatives between the GDNs and stakeholders. Our main criticism of the scheme is regarding the implementation of best practice. We believe a cost/benefit analysis should be carried out as to whether it is the best way to spend customers money before any element of best practice is adopted across the industry.

In terms of retaining the scheme alongside the proposed stakeholder engagement mechanism, we believe in the long run that it should be retained only if these separate schemes are incentivising sufficiently different outcomes and behaviours; if they are not consumers risk paying for the same outcome twice. In the long run there might be scope to ensure that the DRS focuses purely on fuel poverty and vulnerable customer issues. There may however be a need to retain the DRS in the short run until we are satisfied that the new mechanism is delivering comparable benefits to consumers.

Question 6: What interest groups should be considered when designing the customer satisfaction surveys and approach to assessing stakeholder engagement activities?

We believe advice agencies and consumer groups dealing with vulnerable consumers should contribute to this area of work to ensure this group is fully represented. Furthermore, there might be value in considering the opinions of consumer groups that represent larger energy users as well as shippers.

Question 7: Do you agree with the proposed size and structure of the financial reward/penalty associated with each element of the broad measure?

As a package, the +0.5/-0.5 (per cent of base demand revenue) is acceptable. However, we don’t believe the use of an asymmetric financial incentive (reward) for stakeholder engagement will provide strong incentives to engage properly with stakeholders. Only a symmetrical reward/penalty is likely to sufficiently incentivise the network companies to incorporate stakeholders’ views in their business plans.

We agree with Ofgem that any assessment on the effectiveness of the networks' stakeholder engagement needs to be based on the business plans ie there needs to be demonstration of how stakeholder engagement has determined the company's objectives and outputs.

If Ofgem decides to have a discretionary reward only, we believe that 0.5 per cent of base revenue (or £14.15 million per annum assuming annual industry revenue of £2.83 billion, as was the case in 2009/10) is too high an exposure for consumers to face. A reward closer to 0.25 per cent of base revenue would be more appropriate in our opinion (or approximately £7.8 million per annum).

CHAPTER: Four

Question 1: Do you agree with the scope and the timing of the review?

Consumer Focus agrees on both counts. We recognise that there is considerable supplier dissatisfaction with the effectiveness of the user pays regime, and consider that there is merit in many of the complaints that suppliers' have raised regarding the current regime. Although Xoserve costs are only a small proportion of the overall price control, suppliers' ability to differentiate their services might be facilitated, or impeded, by how well the central regime delivers value added services.

It appears to us that there were essentially two underlying principles behind the roll-out of user pays in the last price control:

- to drive the transporters' agent, Xoserve, to adopt a more commercial, and customer-focused, mentality by exposing it to the opportunity of profits (or the risk of losses) dependent on its ability to sell value added services; and
- to allow suppliers' to innovate, and differentiate their services by procuring value added services that help them better serve their customers

These were, and remain, desirable outcomes but we think that they have been hampered by the way the policy was framed at the time of the last price control. Xoserve remains a monopoly provider of value added services and this reduces the incentives on it to manage its costs or the ability of suppliers to challenge or drive down its quotes. In some regards this appears to leave us in the worst of all worlds on cost discipline – with neither the commercial disciplines that genuine competition would bring, nor the cost protection that monopoly price controls can bring.

The introduction of genuine competition, or a retrenchment to full price control, may be better options than sticking with that messy compromise. There may also be value in looking at more radical options around the ownership and provision of central services; is it possible to give suppliers a more direct stake in the delivery of central services? Might a User Participation model such as negotiated settlement be appropriate?

CHAPTER: Five

Question 1: Is the fuel poor network extension scheme still the most appropriate way to assist the fuel poor?

Question 3: Are there other incentives or mechanisms we could put in place to play a role in delivering non-gas solutions?

We broadly agree with Ofgem's view that the GDN's social obligations should primarily seek to meet the heating needs of the fuel poor by the cheapest means possible. Network extensions can clearly play a role but there might be other less costly ways of achieving the same end.

It is our view that at present the cheapest form of heating for consumers is gas central heating. For this reason network extensions will continue to play a major part in providing affordable heating to vulnerable customers. It should be noted that extending the gas network will not be cost effective for consumers unless the network extension is accompanied by the installation of gas central heating. The funding provided to consumers under Warm Front to help install the central heating system is in the process of being reduced. As such to make the network extension scheme viable for a proportion of consumers there might be a need to replace the funding available for the installation of central heating (potentially via CERT or a similar scheme).

In any case, there are a number of different initiatives scheduled to be implemented which could play a role in meeting the needs of vulnerable people. The Renewable Heat Incentive (RHI) has the potential to reduce heating costs for consumers. However, the way the RHI will operate in practice has yet to be finalised. Due to the high upfront cost of renewable heat technologies it will be difficult for low income consumers to take advantage of the benefits of installing renewable heat (and thus gaining the fixed payments which should be provided to consumers once installation takes place). It should also be noted that to make the RHI cost effective the installation of the technology should be completed in conjunction with the fitting of insulation. There might be a need to provide financial assistance to vulnerable customers through the cost of insulation, potentially through CERT (through uplifts) or some other scheme.

Other technologies and developments, such as air and ground source heat pumps and biomass, could potentially provide lower cost heating to the fuel poor in future. However, such technologies are not yet widespread so it is difficult to say with any confidence whether these technologies have the potential to meet the needs of the fuel poor. For this reason we agree with Ofgem that the network extension scheme should continue but should be reviewed as part of a study in 2014. Ofgem and stakeholders should be in a better position then to evaluate the relative cost effectiveness of different technologies and solutions.

Question 2: Which is the best mechanism for delivering fuel poor network extensions?

Consumer Focus believes that option 1 could lead to greater efficiencies but agrees that it will be more costly to administer relative to Option 2, as stated by Ofgem. Therefore we agree that the costs involved (the scheme to date has cost the industry £15 million and is likely to fall as diminishing returns set in) do not merit adopting option 1.

CHAPTER: Six

Question 4: Should we extend existing standards to distributed gas customers? We would also welcome views on whether any new service standards should be introduced for distributed gas, and whether we should revisit this issue during the price review (once the market has developed)?

If the result of extending the current standards is to create a level playing field between competing heat technologies then we have no problem with this. However, there would need to be very good reasons to implement any standards which provide preferential treatment to particular technologies.

Question 5: Should we change any of the existing standards' timescales, penalties, or caps on the penalties (for example, to bring them into line with the guaranteed standards in electricity)?

Consumer Focus believes that the caps on penalties for the existing Guaranteed Standards of Performance (GSOP) should be removed so as to be in line with the decision made as part of the electricity distribution price control (DPCR5). Removing the caps will remove any potential perverse incentives that exist ie failing to resolve a customer issue as the cost of doing so is less than the penalty under the GSOP.

We note that Northern Gas Networks (NGN) might change their 'pro customer stance' in the event that penalties are no longer capped[4]. We hope that NGN would continue to provide a 'pro customer stance' regardless of the removal of capped penalties. Nevertheless, we believe that the removal of the caps is of greater importance to the consumers. There might be a scope to bring the GSOP up to the same standards in electricity distribution in the following cases:

- GSOP 9 – Regulation 10 (3) (e) (i)
- GSOP 10 – Regulation 10 (3) (e) (ii)
- GSOP 4 – Regulation 10 (3) (a)
- GSOP 5 – Regulation 10 (3) (b) (i)
- GSOP 6 – Regulation 10 (3) (b) (ii)
- GSOP 7 – Regulation 10 (3) (c)
- GSOP 8 – Regulation 10 (3) (d)
- GSOP 9 – Regulation 10 (3) (e) (i)
- GSOP 10 – Regulation 10 (3) (e) (ii)
- GSOP 11 – Regulation 10 (3) (f)

However, we believe that any improvements to the standards should only be made where there is clear customer demand for such a change and that changes are cost effective. We would welcome any research Ofgem plans to undertake in this area to see whether changes are warranted in response to customer demand.

CHAPTER: Seven

Question 1: Do you have any views on the primary output and secondary deliverables for gas distribution safety including whether: (4) you agree with our approach to changing the revenue driver for repex from length of main decommissioned to a volume driver of risk removed?

We agree with the proposed approach in changing the revenue driver for repex from length of main decommissioned to a volume driver of risk removed. This change is consistent with the wider RIIO model of focusing on outputs rather than inputs. It should also incentivise network companies to meet there safety obligations in the most cost effective way thus providing value for money for consumers. This is particularly important in light of research produced by Frontier Economics[5] that the incremental costs of the HSE repex programme might outweigh the benefits by more than £400 million.

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[4] Ofgem, Consultation on strategy for the next gas distribution price control – RIIO-GD1 Outputs and incentives (December 2010) p75.

[5] Please see **http://bit.ly/hQg83x**

It should also be noted that that the GDNs are forecasting increasing spend on the repex programme for the RIIO-GD1 period. The need to ensure that consumers receive value for money is vital when the repex funding accounts for approximately a quarter of GDN revenue requirement.

Question 2: Do you agree with the proposed approach of not imposing further incentives relating to safety?

Yes. The legal incentives and penalties which exist mean that further incentives are not warranted.

CHAPTER: Eight

Question 1: Do you have any views on the primary output and secondary deliverables for gas distribution reliability including:
(3) whether it is appropriate to remove the cap on the guaranteed standard for supply restoration and change the level of payments?

We believe that the cap on payments as part of the guaranteed standard for supply restoration should be removed. This should eliminate the potential for perverse incentives whereby the network might face a situation where the costs of restoring a customer's supply might be larger than the cost of the payment under the standard.

Question 2: Do you agree with the proposed approach to reliability incentives?

We are of the view that a financial incentive should be considered for the output on network reliability with regards to minimising off take errors and ensuring adequate redress. Our understanding is that the cost to shippers (which is then passed on to consumers) is material (tens of millions of pounds in some cases) and that the ability to improve performance in this area is sufficiently within the control of the network companies. If this output can be suitably measured by Ofgem to determine network company performance we would be keen to discuss options to implement a symmetrical financial incentive.

On the final output category, we are unsure whether the records and data accuracy output is an appropriate output category. While there is clearly an incentive for the networks to provide accurate data for themselves it is less clear how well incentivised they are to do so for external parties. As such we consider the appropriate output would in fact be the provision of accurate data to third parties. This might be best placed as an output in the connections or customer satisfaction output categories, with the maintenance of network records the secondary deliverable.

Question 3: We would welcome respondents' views on our proposal to require GDNs to develop their approach to valuing interruptible capacity to include a real option value, and views on how to achieve this.

We broadly welcome proposals with the intention of maximising the available options to networks so as to provide a reliable service at lowest cost. Consumers care most about the service they receive not how it is achieved. The equalisation of the marginal incentive rates for opex and capex should also help in this regard.

CHAPTER: Nine

Question 3: Do you have any views on our proposed uncertainty mechanisms associated with the repex review?

We believe that any proposed uncertainty mechanism associated with the repex review should properly take in to consideration the effect on network charges to end users. Such a mechanism might lead to increasingly volatile network charges, with the associated cost absorbed by end consumers. Any changes to network charges that result from the uncertainty mechanism must fully take it out the financial impact of such changes.

Annex: Tools for cost assessment

CHAPTER: Two

Question 1: Do you agree with our approach for assessing the companies' business plans?

We broadly agree with Ofgem's approach. There are two main points we wish to make. Firstly, the annex states that more emphasis will be placed on forward looking forecast data as part of the cost assessment process with less emphasis placed on historic cost data. We believe it is important that Ofgem looks to make use of both methods as they have advantages and disadvantages. Furthermore, the forward looking and backward looking approach will often complement one another (ie one method reinforcing the results of the other). Secondly, we believe it is entirely appropriate that cost assessment techniques should be used to assess the GDNs' business plans. The results of such analysis should inform Ofgem on decisions relating to fast tracking and proportionate treatment. We would also welcome seeing evidence of the benefits to consumers from the sales of the distribution networks in 2004 as part of the cost assessment process. Ofgem believed that benefits valued at between £80m and £225m[6] would be realised and that the majority of these benefits would go to consumers by the time of the next price control.

CHAPTER: Four

Question 2: Are our tools and techniques adequate for assessing the GDNs expenditure plans?

We are aware of the benefits, in terms of more accurate and reliable data, of using panel data techniques and welcome its use in the RIIO-GD1 process[7].

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[6] See Potential sale of gas distribution networks businesses: Final Regulatory Impact Assessment, Appendix 6 (November 2004) p51.

[7] Please see **http://bit.ly/ij4eeC** for a discussion of the benefits of using panel data techniques in price control determinations.

Annex: Business plans, innovation and efficiency incentives

CHAPTER: Two

Question 3: What are the appropriate criteria for assessing whether a proposed change to the revenue profiling is appropriate?

Any assessment on whether changes to revenue profiling should be made must take into account the interests of end consumers; ie if by re-profiling revenues the total costs to consumers will be lower than they otherwise would be without re-profiling (potentially through a reduction in the cost of capital) then this would represent a legitimate reason for change. If the opposite was the case then there would be no legitimate rationale for re-profiling. The effects on both current and future consumers should also be considered with the level of funding related to the use and consumption of services and assets.

CHAPTER: Three

Question 1: Are you content with the degree of guidance we are providing on a well-justified business plan? Is there additional guidance you would value?

We are confident we understand what our role is in helping network companies develop well justified business plans which reflect the views of their stakeholders. We are particularly interested to see how stakeholder engagement is used to develop these business plans. We await network companies' business plans with interest.

Question 4: What should be included in our assessment of past performance at these first reviews?

A by no means exhaustive list of the metrics to be considered is provided below:

- Performance in relation to the Information Quality Incentive (IQI)
- Customer satisfaction performance
- Compliance with the guaranteed standards of performance (GSOP)
- Cost assessment data and analysis on opex, capex, repex etc.
- Performance again the Return on regulated equity (RORE) metric

Question 5: Do you have comments on the proportionate treatment process?

We are broadly happy about the proportionate treatment process. It is good that there will not be in effect three standard types of price control processes for the network companies (fast track, normal and intense regulatory scrutiny). It is sensible that the regulator focuses its resources on the areas where there is most dispute about a network's business plan.

This should provide incentives to companies who believe they do not have a chance of fast tracking but can still receive lighter regulatory treatment if they provide accurate forecasts and data. Such forecasts and data mean that consumers are more likely to receive a fair regulatory contract.

We would however urge Ofgem to err on the side of caution when it makes their decisions on where to target their regulatory resources. If there is any doubt about the accuracy or detail of a company's business plan Ofgem must commit adequate resources to ensure that consumers' interests are protected.

Question 6: Do you have comments on our assessment criteria?

We completely agree with Ofgem that the assessment criteria should be set in terms of the absolute quality of the business plan and not the relative strength of the business plan compared to other GDN business plans.

We believe the assessment criteria is sufficient robust and comprehensive at this stage. The only amendment we would suggest is to add 'evidence of the consideration of alternative scenarios/outputs' to 'Criteria 1 – Key content'[8]. We recommend this addition because we believe that the development of alternatives scenarios and outputs provides important benefits for Ofgem, stakeholders and ultimately consumers. Firstly, providing alternative scenarios allows stakeholders to evaluate the different outputs that could be provided and the scenarios' specific costs. This should make stakeholders better informed about the different options which are possible. Secondly, the development of alternative scenarios demonstrates where the networks have been seeking to provide better value for money.

Question 7: Do you support the way we propose to apply fast-tracking?

We are broadly supportive of the fast-tracking proposals. The aspects we highlight to Ofgem on the proposal relates to the need to consult stakeholders on any decision to fast track network companies and also the use of Ofgem's regulatory judgement/discretion. Firstly, the ability of stakeholders to evaluate the decisions Ofgem is taking on fast tracking and the ability to challenge any decision provides an appropriate check and balance on Ofgem's ability to fast track companies prematurely. Secondly, we would urge Ofgem to exercise caution in the decision it takes on fast tracking. If Ofgem is in any doubt about any part of a network company's business plan it should not use the fast tracking option.

It should rather fall back on the proportionate treatment process, providing regulatory scrutiny where doubts about a network company's business plan exists and refraining from undue scrutiny where agreement between regulator and network is clear.

Question 8: For RIIO-GD1, do you have views on the additional reward reflecting their relative superiority over comparators. Which of the options for implementing the reward do you prefer and why?

We are unsure whether this additional reward is justified. Network companies which are judged to be superior to their comparators can expect to be potentially fast tracked, with the resulting benefits this treatment provides, or at least receive lighter regulatory scrutiny in line with Ofgem's proposals on proportionate treatment. The only justification we believe exists for providing an additional reward is that it could provide greater incentives for companies to provide a greater quantity and accuracy of data and forecasting which will help Ofgem make better regulatory determinations for the benefits of consumers.

However, it is our view that the fast tracking process (and proportionate treatment as a whole) should provide the necessary incentives for companies to provide reliable data (as well as the IQI). Therefore to propose an additional reward could only be justified if this was to provide additional benefits in terms of improving Ofgem's regulatory determinations (which is consistent with protecting consumers' interests). At present we do not believe an additional reward has been justified.

[8] Ofgem, Consultation on strategy for the next gas distribution price control – RIIO-GD1 Business plans, innovation and efficiency incentives (December 2010) p18-19.

However, if the additional reward can be justified, our preference is to implement a reward based on a percentage of the consumer benefit from Ofgem's benchmarking work. We believe this is preferable in comparison with a reward set as a specific amount as the percentage approach is more likely to strengthen incentives for companies to submit challenging forecasts which will drive greater efficiencies for benefit of consumers.

CHAPTER: Five

Question 1: Should the scope of the innovation stimulus be confined to projects which help deliver a low carbon future, or should the scope be wider to include long term network sustainability? Should there be a different scope to the innovation stimulus that applies to electricity and to gas?

We believe that the scope for funding projects (both gas and electricity) as part of the innovation stimuli should apply to projects which facilitate a low carbon energy sector and which deliver long term value for money for consumers. These two objectives are the high level objectives of the RIIO framework and in some cases can be expected to be compatible with one another. The funding of the innovation stimuli will also be funded mainly by consumers so they should expect to see a proportion of projects submitted which are intended to lower the costs of networks services for them in the medium to long term.

We recognise by extending stimuli funding to projects which deliver long term value for money for consumers there might be a risk that consumers pay twice for innovation that would have been completed in the absence of stimuli funding. However, we reiterate the point made in our response to Ofgem's open letter consultation on innovation[9] that the innovation stimuli should only be for funding more speculative innovation projects which could not be funded economically or on commercial terms. The stimuli should not be for 'business as usual' innovation. As such this risk should be mitigated.

Question 2: Do you agree that the level of funding available under the innovation stimulus for each of electricity transmission and gas distribution and transmission should be within the ranges identified? Are there further arguments for different funding levels which we have not considered?

We are comfortable with the total level of funding which Ofgem is proposing be made available under the innovation stimuli (electricity transmission and distribution and gas transmission and distribution). However, we believe that Ofgem needs to be certain that by providing differential levels of funding to electricity and gas networks it will not unintentionally 'pick winners' ie it is not seen to be unduly favouring one energy source over another.

Question 3: How should network companies be required to meet the costs of the innovation stimulus? Should this be through fast cash, slow cash or the standard expenditure capitalisation ratio?

We believe that Ofgem should re-evaluate their initial position on the mechanism to meet the costs of the innovation stimuli. We are not convinced that funding the stimuli via the standard expenditure capitalisation ratio is beyond the ability of Ofgem to deliver. Ofgem should focus its efforts on making this mechanism work. This is because this mechanism will lead to the fairest outcome for current and future consumers (who should share the funding requirements of the innovation stimuli).

[9] **http://consumerfocus.org.uk/g/4nm**

This is particularly the case as we can expect future consumers to be the main beneficiaries of any innovation stimuli project successes. Providing funding for the innovation stimuli entirely by 'fast money' will place undue financial strain on current consumers.

Question 4: Do you agree that we should provide a limited innovation allowance directly to each company? If so, do you have views on the form and scope and of this allowance, and on which mechanism would best incentivise efficient investment in innovation?

We believe there is potentially some value for consumers in allowing companies a limited innovation allowance. If such an allowance is given we would prefer if a mechanism as outlined for option 2 was implemented. We believe that a outputs-based approach, justified in part by networks' business plans, would be more likely to provide value for money for consumers and focus innovation on areas which consumers value ie reduce the risk of 'gold plating' or plain wasteful expenditure. We recognise this approach would be more difficult to implement in comparison with a fixed allocation (option 1). However, we believe option 1 is more likely to provide poor value for consumers' money and for this reason believe Ofgem should endeavour to implement something similar to Option 2.

We would also note that a ceiling equivalent to 2 per cent of allowed revenue is slightly excessive. The network companies would have to demonstrate the benefit to consumers of having such a ceiling would at least outweigh the consumer outlay. If this cannot be demonstrated we'd recommend that the ceiling be set at a range between 1-1.5 per cent of allowed revenue.

Question 5: Do you agree that there should be a revenue adjustment mechanism to encourage innovation roll-out within the price control period? If so, do you agree with our views on the criteria for such an adjustment and how frequently should we allow companies to apply for this adjustment?

We are broadly content with such a revenue adjustment mechanism. If such a mechanism was adopted we would argue that option 2 (a single point to apply for funding) rather than option 1 (an annual opportunity to apply for funding) would be more appropriate. This is because a single opportunity will minimise the resource costs for the regulator and the networks. It should also be sufficient to take account of new developments which might affect the development of innovative projects.

CHAPTER: Six

Question 1: Do you agree with our proposed approach to the implementation of the efficiency incentive rate? Do you have views on the intergenerational impact?

We are broadly content with Ofgem's approach. The range provides a suitable compromise between the risk sharing expected to be undertaken by consumers and shareholders. At the same time it should prevent any negative effects that can occur when the Regulatory Asset Value (RAV) comes to be adjusted.

Question 6: Do you have views on the scope for alignment between the TO and SO incentive schemes, including greater alignment than we have proposed? If you disagree with our proposals in these areas, please explain the basis for an alternative approach

We support the broad principle of seeking to align System Operator (SO) and Transmission Owner (TO) incentives because this should encourage those firms that possess both roles with better incentives to identify and choose the lowest total cost solution for consumers, and to make smarter trade-offs between asset based and commodity based approaches to managing the system. Although there may be instances where factors such as visual amenity may make commodity based approaches preferable, in general consumers will not care which approach is taken provided the lights stay on – which suggests that the strength of incentives provided should not unduly discriminate between capex and opex solutions.

We consider that aligning SO and TO schemes might be more difficult on electricity than on gas. Partially this is because the electricity SO scheme has been less demonstrably fit for purpose in recent years, with ex post costs often wildly different from ex ante estimates. In addition, the electricity system is likely to be subject to greater change than gas in the coming years. This may make setting long term SO schemes difficult (ie greater risk that out-dated targets/outputs could become locked in for an extended period). If Ofgem can find pragmatic ways to tackle these risks, there is value in further exploring ideas around SO/TO alignment.

Annex: Uncertainty mechanisms

CHAPTER: Three

Question 1: Do you think there should be a change to a 12-month average approach to RPI indexation of allowed revenues? If there were a change to a 12-month average approach, would there need to be any transitional adjustments?

We believe there is some value in moving to a 12 month average approach to RPI indexation of allowed revenue. Such a change has the potential to reduce the volatility of the indexation measure which could help reduce any impact on network charges. This could potentially result in cost savings for consumers. Therefore we think Ofgem should investigate further the two 12 month average options proposed ie the April to March 12 month average and the January to December 12 month average.

Question 2: Do you have any views on the design of the reopener for the introduction of Traffic Management Act permitting schemes? In particular, is the timing of the reopener window appropriate and what approach should we adopt to set the materiality threshold before it can be triggered? Do you agree with our proposal that the reopener would only apply in gas distribution?

Generally, we are supportive of the approach Ofgem intends to apply. We think it should maximise the incentives on networks to act efficiently thereby providing value for money for consumers.

CHAPTER: Four

Question 2: Do you agree with our proposal to remove the loss of meter work revenue driver? If not, why do you think retaining the mechanism is in the consumer interest?

We agree with Ofgem that the loss of meter work revenue driver should be removed. This is because it could provide perverse incentives to network companies to lose metering business if the revenue driver over compensates the networks financially for a loss of custom. This is not in line with driving efficiencies in network services and as such could lead to consumers receiving poor value for money. This measure was only implemented as a transitional measure. We would argue that the time of transition will almost certainly have passed in 2013.

CHAPTER: Seven

Question 1: Do you agree with the scope of the mid-period review? If not, what changes to the scope are needed?

We initially had concerns about how the mid-period review would work in the context of an eight year price control. These concerns were illustrated in our response to the RPI-X@20 recommendations consultation[10]. Having reviewed the way Ofgem intends the mid-period review to function we believe many of our concerns have been alleviated. The main point to make is that it is right that Ofgem has tightly defined the scope of the mid-period review ie only changes to the outputs that network companies are expected deliver will be considered as part of the review. It is also very important that Ofgem does not resort to retrospective changes. In sum, the process as laid out should minimise the risks to the longer term price control and ensure that the potential benefits to consumers of extension are not lost.

Question 2: Do you agree with the indicative process and timetable? If not, how could the process and timetable be improved?

We believe that Ofgem should reconsider its rejection of implementing quantitative thresholds (in terms of the implications for allowed revenue) at the start of the mid-period review. Such thresholds could help guide Ofgem as to whether a change in the external environment warranted adjustments to the outputs. This could help provide greater certainty over the 'regulatory contract' and help reduce the cost of capital. Ofgem should explore the pros and cons of such an approach in greater detail before coming to a decision in March 2011.

Also, we consider that both Ofgem and the network operators should undertake stakeholder engagement as part of the mid-period wherever appropriate as has been the case with stakeholder engagement for RIIO GD1 and T1.

[10] **http://consumerfocus.org.uk/g/4nmb**

Annex: Financial issues

Chapter: Two

Question 1: Do you agree with our proposed economic asset lives for gas and electricity transmission and gas distribution?

We are in broad agreement with the RIIO principle that regulatory asset lives should reflect the average expected economic life of the related network assets. This should help ensure a fair balance between the interests of current and future consumers as the funding for such networks is spread on the basis of who uses the assets.

In terms of the asset lives for gas transmission and distribution, we agree with Ofgem's view that the current regulatory asset lives should continue to be set at 45 years. We agree that there is significant uncertainty surrounding the future usage of gas; some scenarios point to an important future for gas, others to falling use and increased electricification of Britain's energy consumption. The breadth of potential scenarios becomes increasingly apparent after 2020 (in analysis produced by Redpoint, Ofgem etc.[11]). For these reasons we believe it is sensible to retain the current regulatory asset lives to ensure a fair balance between the interests of current and future consumers. The potential to better review the regulatory asset lives will be greater at the time of the next price control determination (expected to be in 2021 although negotiations will begin a few years in advance) when the future use of gas should be clearer.

We agree with Ofgem's assessment that the economic lives of electricity transmission and distribution network assets are likely to be far longer than those currently assigned a 20 regulatory asset life.

There is greater certainty in the future energy scenarios analysis that electricity consumption will increase in future. Furthermore the CEPA report shows that the technical and economic asset lives of electricity network assets is likely to be far greater than 20 years (or the regulatory asset live). As such we agree with Ofgem's view that the regulatory assets lives for electricity transmission and distribution assets should be increased to somewhere between 45 and 55 years. We believe this will ensure a fairer balance between the interests of current and future consumers as the funding for the assets will be more closely aligned with the use of these assets (due to the lengthening of the depreciation profile).

Question 2: Do you agree with our proposals for the depreciation profile?

We are in broad agreement with the stated objective that depreciation profiles should reflect the speed at which assets are used. This should ensure a fair balance between the interests of current and future consumers.

We agree with Ofgem that a straight line depreciation profile for electricity transmission and distribution should be retained. We also agree that a straight line depreciation profile should be retained for gas transmission assets as well as existing gas distribution network assets.

However, we do not believe that the case has been made that there is a need to front load the depreciation profile for new investment in gas distribution networks ie current consumers can expect to pay more relative to future consumers. The reason given by Ofgem for the need to front load the depreciation profile is because it believes there is a risk that gas consumption on the distribution network might fall significantly towards the end of the eight year price control period.

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[11] These reports are evaluated in Ofgem's commissioned report on 'The economic lives of energy network assets'. Please see **http://bit.ly/dVPLmf**

This could lead to significant increase in the unit costs of the distribution network (as a large proportion of the costs of the network are fixed). As such there might not be enough gas consumers to fund the fixed costs of the network assets (potentially the higher costs could make gas more uncompetitive in comparison with other fuels thus accelerating further reductions in the demand for gas – a 'graveyard cycle' potentially).

It is our view that this risk is not sufficiently clear at present to warrant a frontloading of the depreciation profile (for example the Redpoint Energy report undertaken for the Energy Networks Association[12] suggests that even 'low gas' scenarios could see annual gas demand remain stable until approximately 2025 due to growth in new connections on the distribution network). Ofgem needs to provide a much greater level of evidence to justify such a position. Furthermore, the effect on current consumers and affordability needs to be taken in to account. Consumers are being asked to help fund increasing number of governmental policies to help reach statutory carbon targets (the Electricity Market Reform proposals, the Energy Company Obligation etc.).

Our fear is that by levying further costs directly on to current consumers could lead to affordability issues resulting in increasing levels of fuel poverty. In fact by front loading the depreciation profile there is a risk that this might trigger a switch away from gas leading to a self fulfilling prophecy of less gas demand and greater unit costs.

Question 3: We invite views on our proposed approach to transition.

We are of the view that the onus must be on the network companies to clearly demonstrate that a change (or no change) in assets lives and/or depreciation profiles will lead to insurmountable difficulties in their ability to efficiently finance their regulated activities. Only then would transitional arrangements, as discussed by Ofgem, be warranted. We would also want the benefits of transitional arrangements to network companies (and potentially customers by a reduction in the cost of capital) to be weighed against the drawbacks to current consumers through higher charges than would be the case if there were no transitional arrangements.

We would also note that both CEPA[13] (on a theoretical basis) and Europe Economics[14] (on a empirical basis) have concluded that lengthening the network companies cashflows do not seem to have a negative effect on a utility's cost of capital and therefore should not lead to significant concerns over the financeability of a utility's regulated activities. We are only aware of the purely theoretical arguments put forward by Oxera[15] on behalf of the ENA that the opposite is true ie a lengthening of cashflows increases a regulated company's cost of capital.

Furthermore, we note the RPI-X@20 conclusions in that Ofgem have stated it is for the network companies themselves to address short term falls in cash flow metrics: 'the onus would be on the company to resolve the situation, including by injecting equity and/or reducing dividend payments as they see fit'[16]. We understand that there is significant investor interest in infrastructure assets. Therefore such interest should improve the ability of the networks to manage their cashflows via other means (such as equity injections) rather than by transitional arrangements. These methods are more likely to balance the interests of current and future consumers in a fairer way.

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[12] See **http://bit.ly/fSvMLh**
[13] *RPI-X@20: Providing financeability in a future regulatory framework* – a report by CEPA on behalf of Ofgem **http://bit.ly/ezlN7C**
[14] *Europe Economics, The weighted average cost of capital for Ofgem's future price control*, Final phase 1 report (1 December 2010)
[15] Oxera, *What is the impact of financeability on the cost of capital and gearing capacity?* (July 2010) and *Cash-flow profiles and the allowed WACC – a response* (September 2010).
[16] Ofgem, *Regulating energy networks for the future: RPI-X@20 Recommendations: Implementing Sustainable Network Regulation* (July 2010)

CHAPTER: Three

Question 2: What impact do our proposals for RIIO-T1 and GD1 have on the companies' cashflow risk, and does this have a material impact on how the allowed return should be set?

While we can't comment on the specifics on the question we would say that it should be for the network companies to demonstrate unambiguously that the proposals will have a negative effect on cashflow risk and on financeability. Only then should the allowed return be set in a way which mitigates this risk.

CHAPTER: Five

Question 4: Do you agree that clawback of the tax benefit of excess gearing in TPCR4 and GDPCR1 should be spread over the eight years of the RIIO price control? If not, which alternative option do you prefer?

We agree that the clawback should be spread over the eight years of the RIIO price control. We believe that smoothing the adjustments over an eight year period should provide the following benefits for consumers. Firstly, the potential for costs to consumers to increase significantly in the first year of the RIIO price controls will be mitigated. Secondly, spreading the revenue adjustments evenly over the eight years should reduce an element of volatility in network charges. Such volatility can potentially come at a significant cost to end consumers.

CHAPTER: Six

Question 1: Do you agree that the timing of true up adjustments for existing controls should be spread over the eight years of the RIIO price control? If not, which alternative option do you prefer?

We agree with this option for the same reasons given in answer to question 4, chapter 5.

Question 6: How should we account for the costs of issuing debt?

We believe that a separate allowance for the costs of issuing debt is unnecessary. We understand that efficient network companies are able to issue debt at a lower cost than the average of the suggested index.

Annex: RIIO-T1 outputs and incentives

Chapter 5

Question 5: What role is there for a primary output in RIIO-T1 on TO's contribution to the UK's environmental and energy objectives and what type of incentive would be most effective to drive TOs delivery in this area?

Question 6: Do you have any additional views on RenewableUK's proposal for a specific low carbon economy output including the form and size of such a reward mechanism?

We are not able to support RenewableUK's proposal as it is currently envisaged. We believe the case has yet to be made that a financial incentive should be placed on a broad low carbon economy incentive. This is for the following reasons:

The output is not sufficiently within the control or influence of network companies. There is a serious risk that the networks will make windfall gains on the back of activities undertaken in other markets and by Government (if it is a reward only) and potentially windfall losses (if it is a symmetrical incentive). This is especially true of the two broad indicators suggested by RenewableUK, namely:

- Percentage of total generation originating from the network (or GB system), or
- Carbon intensity of energy flowing on the network (or GB system)

There is a risk that consumers will 'pay twice' to meet statutory carbon targets ie the low carbon economy incentive is probably superfluous due to other regulatory and Government initiatives. There are already a number of different policies which are in the process of being implemented which intend to incentivise market participants to meet statutory carbon targets. These will require consumer/taxpayer funding (the EMR, FITs, ECO, RHI etc).

Furthermore, the list provided by RenewableUK[17] which states how network companies can play a full role in the delivery of a sustainable energy sector could be incentivised under different output categories (connections, customer satisfaction, the innovation stimulus etc). For example, the need to connect generation more quickly could be incentivised under the connections output. Smart grid and active management schemes could be potentially incentivised and funded under innovation/innovation stimulus. Identifying means of connecting heat pumps could be incentivised under a customer satisfaction output etc.

Perhaps most importantly, it is unclear how a low carbon economy incentive would provide benefits to consumers in terms of meeting carbon targets in a lower cost manner. The RenewableUK policy paper contains a forecast on potential CO_2 savings[18]. However, it is unclear how realistic the assumptions made are ie would an additional 1,000MW of low carbon generation be brought forward by a year for every year of the price control in the absence of an output reward?

Finally, there might also be unintended consequences in terms of the effects on efficient competition in related energy markets which needs to be better considered by all market participants.

If Ofgem decided to implement a low carbon economy output with a financial incentive we believe that the incentive must be symmetrical to prevent all financial exposure being placed on consumers. It is our opinion that a symmetrical incentive (stick and carrot rather than just carrot) is more attractive as it would be more likely to incentivise the type of network behaviours the RIIO framework is trying to encourage ie encouraging the networks to play a full role in the delivery of a sustainable energy sector (assuming that the output is sufficiently measureable and controllable of course). Furthermore, we argue that the size of the financial incentive should be reduced, closer to 1 per cent of total transmission revenues to reflect the degree to which the output incentive is within the control of the network companies.

However, if it can be demonstrated that such an output measure can deliver a defined level of output (in this case the achievement of statutory environmental targets) for consumers at lowest total industry cost we could change our minds. We note that RenewableUK intend to develop evidence to show that the additional costs in the regulated income of the companies will be offset by savings elsewhere in the energy market. If you they (or anyone else) are able to demonstrate this is the case we could then be in a position to reconsider and potentially support such a proposal.

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[17] RenewableUK, Initial proposals for RIIO and specifically RIIO-T1: The Low Carbon Economy Incentive (LCEI) (December 2010) p8-10.
[18] Ibid, Fig. 6, p13.

Consumer Focus response to Ofgem's consultation *Strategy for the next gas distribution price control RIIO-GD1 and transmission price control RIIO-T1*

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