RIIO GD1 – BUSINESS PLAN

CHAPTER 2 - Form and structure of the price control

Question 1: Do you have comments on the description of the form and structure of the price control?

Not at this stage.

Question 2: Is the scope of the price control including the range of services excluded appropriate?

Yes but given the extended length of the price control and uncertainty over the future of how the decarbonisation agenda will impact it is important that flexibility is retained in this area. Should there be a requirement for GDNs to provide new services then having these treated as excluded services at least until the next price control may be the most appropriate way of encouraging any development and response by the GDNs.

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

Material variances in network cash flow whilst maintaining current gearing levels which are likely to adversely affect credit ratings and / or financing should be taken into account when assessing any proposed change to revenue profiling.

CHAPTER 3 - Business plans and proportionate treatment (including fast-tracking)

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?

At this stage NGN are content with the level of guidance set out within the documents and believe the level of detail is sufficient to allow companies to further formulate their thinking on the structure and content of their business plans.

However, we also recognise that all parties are using this framework for the first time and further points of clarification may arise as the process progresses.

Question 2: Do you have comments on the use of ten years as the basis for forecast data? What level of detail should additional five years data to place this forecast into context be? Where might a longer period be appropriate? Are there cases where ten years would be problematic? If so what alternative approach might we follow?

Given the proposed duration of the next price control will be 8 years, ten years as the basis for the forecast data must be appropriate. Forecasting over this longer period will undoubtedly include element of uncertainty in certain areas of the forecast. In some of these areas the use of a probabilistic assessment of expenditure requirements will be appropriate to address uncertainty and is a consequence of the longer duration of expenditure forecasts. However, the companies should highlight these uncertainties with the business plan and how these have been addressed in the proposals.

An additional five years of forecast data will be useful to support the longer term context that companies will be considering within their plans. However, forecasting over this time will not be possible with any degree of accuracy at the level of detail included within the ten year forecasts to 2021. Consequently the additional five year forecasts should be at a summary level for each of the main areas of expenditure over the period allowing identification of the main issues, trends and uncertainties that may exist during that period. This should provide a robust basis for considering the longer term context of the business plans.

Question 3: Do you support the basis of our initial sweep assessment?

NGN supports the basis of your initial sweep assessment. In particular the recognition of the challenges of developing this form of business plan for the first time will present and the potential flexibility for outstanding issues to be addressed within your timescales to ensure that all criteria are met.

To the extent that the assessment against the stated criteria will largely be qualitative and therefore more subjective in nature. It would be useful if any further development of Ofgem's approach to assessment of these criteria could be shared with the companies in advance of the business plan submission in July.

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

At the initial sweep stage of the process, the assessment of past performance should be based on three broad areas that:

- Robustness of previous price control review submissions including forecasting of expenditure and could take into account evidence form IQI allowances at last review and final allowances against business plan forecasts.
- Past efficiency performance using Ofgem's proposed framework for cost assessment.
- The robustness of companies explanations of performance against regulatory allowances.

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

We broadly agree with the proposed proportionate approach to the assessment of the price control package. The principle that a company that provides a well justified business plan, has delivered a strong track record and is operating at the efficiency frontier should not be exposed to the full price control review process is a sound basis, we believe, for applying the proposed framework.

However, as Ofgem has recognised, in applying the principle of proportionate treatment the incentive properties of the whole RIIO framework need to be fully considered and not undermined by the approach taken. In particular, the application of the proportionate approach must:

- Not set the threshold(s) for proportionate treatment and in particular fast-tracking at a level that is unrealistically high. The incentives for companies to achieve fast-tracking must be real and achievable.
- Not undermine the wider efficiency incentives of the RIIO framework. Companies who are fast-tracked or are subject to a reduced level of scrutiny should be positively rewarded by the proposed approach. The recognition of this point within your proposals is a welcome clarification and is key to the success of the proportionate treatment and fast track approaches.

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

We have no detailed comments on your proposed assessment criteria at this stage. They, along with the Business Plan guidance, provide a useful basis upon which the companies can begin to develop their business plans for submission in July.

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

We support the principle of fast tracking and the approach that you are proposing to take to the process for fast-tracking.

The process must however ensure that the incentives for efficiency are not affected by the application of this process. In particular the treatment of those companies that are operating at or close to the efficiency frontier must receive allowances that reflect the value that they are creating across the industry by operating ahead of the upper quartile measure of efficiency and hence driving the efficiency frontier.

We welcome your recognition of this issue within the document and the proposal to ensure that the most efficient company(ies) receive allowances in accordance with the upper quartile benchmark and are not disadvantaged by the fast-track process.

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?

Before looking at the available options it is important that Ofgem recognise an important principle it adopted in DPCR 5 which is within the average rate of return companies that have demonstrated frontier in current price control performance should be rewarded more significantly than companies that underperform. In DPCR 5 that SSE and WPD both received explicit rewards for such performance on opex and capex respectively. Overall extending this approach under the RIIO framework one would expect that companies with proven frontier performance like NGN, and which are proposing continued frontier performance in their business plans should receive the highest reward or scope for outperformance given their established creditability.

With this in mind we can then turn to issue of options for providing reward the two mentioned are:

1. a value based on proportion of consumer benefit as derived by Ofgem benchmarking other companies i.e. the value of having the frontier company as a comparator;

2. a value (an allowance) proposed by companies as part of their well justified business plan

With regards to the above options we believe that the second is the most practical as Ofgem note the first option will require data from other companies that will not be available at the time of the fast tracking process. We believe the second option is more viable, against the context of the "well justified business plan" companies will have to justify how any proposed allowance for additional reward relates to benefits delivered from historic and future frontier performance.

CHAPTER 4 - Greater role for third parties in delivery

Question 1: Do you agree with our view that the case to develop the framework to enable third parties to compete to develop and own elements of the electricity transmission network is significant, and that we should work to develop this option as a priority? Do you foresee any areas of significant benefit or concern?

Note: These two questions relate to electricity and gas transmission (as per SP response).

Question 2: Do you consider there is a case for introducing competition for development and ownership of gas transmission assets? What form this should take? Do you foresee any significant barriers to the development of a competitive regime? When would be the appropriate time to develop this option?

Note: These two questions relate to electricity and gas transmission (as per SP response).

Question 3: In light of the role competition already plays in gas distribution do you feel there is a case for making further provisions to enable new entrants to develop and own parts of the network? If so, what form do you think these provisions should take?

NGN agrees that that third parties already play a significant role construction and ownership of new gas distribution assets and that no further provisions are needed in this area.

CHAPTER 5 – Innovation

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?

To limit the scope of the type of projects that can be adopted would be a retrograde step. The projects should be focused on delivering overall network efficiencies; this in turn may have additional benefits in delivering low carbon solutions, e.g. reduced leakage lower pressure in systems etc.

Consideration could be given to scoring or weighting projects so as to promote lower carbon projects but do not exclude other projects and allow sufficient scope to economically develop the network, the pipeline structure may have some other as yet unseen benefit e.g. associated with carbon capture and storage, biogas, bio fuel etc.

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?

Agree with the level of funding proposed but only if it is allocated on a fair and equitable basis between transmission and networks.

Being an efficient GDN does not allow the carrying of a dedicated in house R&D resource and consideration should be given to allowing the full internal cost of resources used.

In our opinion reducing the maximum funding to 80% from 90% reduces the incentives for investing and is a retrograde step.

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 would agree with your preferred position that funding for projects under the innovation stimulus should be via Fast Money. This has several key benefits within the overall RIIO framework:

- The mechanism for recovering expenditure from within regulated revenues is much simpler;
- It has no impact on the overall incentives for carrying out such investment where the proposal; and
- It will not impact upon the wider financeability issues raised elsewhere within the proposals. Funding of innovation via slow money or the standard capitalisation ratio would required that investors account for any future innovation investment in their assessment of the overall financeability of networks.

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?

NGN supports the view that the IFI has provided a good framework for beginning to stimulate R&D and innovation in areas that in areas that networks might otherwise have not chosen to apply resource and expenditure including issues relating to the development of renewable gas and the move to a low carbon economy. The GDNs have been building an understanding of the IFI framework and where it can be used individually and potentially collaboratively to address the key issues within the industry. We support the retention of an arrangement that includes the beneficial elements of the current IFI scheme and allows the GDNs to build upon the understanding gained over the first three years of operation.

The scope of such arrangements should be in line with that of the current IFI arrangements. Limiting the scope to low carbon would exclude schemes that would otherwise deliver longer terms benefits for customers in terms of network sustainability and value for money.

The appropriate mechanism for the funding of such arrangements must consider the overall risk and reward of these arrangements and the incentives this consequently provides for GDNs. We believe that your Option 1 provides an overall better balance of risk, reward and incentives.

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?

NGN supports an incentive regime aimed at ensuring that benefits of R&D and innovation are delivered as early as possible to customers. This is especially the case where the benefits of implementing new innovation largely accrue outside of the GDNs as is primarily the case with low carbon innovation.

The criteria outlined for assessing such expenditure are broadly correct, simply the criteria they should focus on whether implementation of the innovation will provide longer term benefits to customers and if, without any acceleration of allowed of expenditure, the innovation would be adopted in a timely manner.

On balance we believe that Option 1 would provide sufficient incentives for the adoption of such innovation. The additional administration required for this approach would not be significant.

CHAPTER 6 – Efficiency incentives and IQI

This is a critical area of the new RIIO framework and central to its success or failure. There are a series of interactions between historic cost assessments, business plan forecasts, the Totex IQI and setting allowances which are not yet clear to us. Our comments therefore should be considered in this context and it may be we have not fully understood the processes to be followed. The provision of some clarity on how these interactions will operate under RIIO is a key output for the March document.

Our views on the proposals as we currently understand them are:

- **The incentives on information quality**

  This is a key element of the "well justified business plan". Under the existing IQI matrix this is achieved by awarding the highest incentive rate and additional reward for companies that forecast in line with Ofgem's view on costs i.e. at 100%.

  Under the proposals set out in Chapter 6 it would appear that the criteria for a " well justified business plan" is one that forecast costs lower than Ofgem's views of efficient levels of costs. i.e. at 95% as there is no reward for being in line with Ofgem's view of efficient costs. Companies who forecast costs exactly in line with Ofgem's assessment will only receive returns equivalent to the cost of capital. Referencing one of the main purposes of the IQI is to incentivise accurate forecasting the proposed approach seems to be counter-intuitive.

  This represents a very significant step change to the previous application of this element of the IQI framework - particularly as the assessment will be an amalgam of all the costs that go into Totex. It also raises the question of whether the "well justified business plan" being sought by Ofgem is realistic. The definition of a well justified business plan cannot exclude a plan with a level of costs that Ofgem deems as efficient.

  To address this problem we suggest that:

  1. Ofgem returns to the original IQI scale as the starting point with the present level of additional reward for a 100%:ratio; and

  2. The scale of rewards and incentive rates should be "steepened" so that there are greater rewards for business plans going towards the ratio of 100% and greater penalties for plans that go in the other direction.

- **The Incentives on efficiency**

  This comprises two elements:

1. The reward for having achieved historical frontier performance to maintain incentives across price control periods

Under RPI-x the reward for historical performance has been dealt with outside the IQI matrix by having upper quartile allowances for frontier companies. For example at DPCR 5 SSE and WPD received explicit allowances for frontier performances on opex and capex respectively.

It would appear that the Totex IQI does not cover historic frontier performance and in which case a separate allowance for this would need to be developed as appears to have been the case in DPCR5. Such an allowance would need to be included in any well justified business plan to enable such a company to be potentially fast tracked.

Clearly, if Ofgem intends the IQI to cover this element then the link between historic cost benchmarking and how this feeds into the assessment for the IQI needs to be established.

2. The incentive rate for any future efficiency in the next price control period.

With regard to the future incentive rate the starting point is the strength of the overall incentives Ofgem wishes to see within the sector relative to the current position. Our understanding of the policy intent is to equalise incentives across different types of expenditure (opex, capex, repex) rather than strengthen or reduce the overall incentives. If this statement is correct then the current proposals for gas distribution do not achieve this as at best a frontier company who obtain 60% incentive rate would have an overall incentive strength broadly in line with the current price control. Therefore the average position across the sector would be a reduction in the incentive strength.

This arises in part because of the lower levels of capital (including repex) expenditure in gas distribution compared to the electricity distribution and transmission companies. Also the proportion of costs subject to the incentive (i.e. within the totex definition) are greater than in electricity distribution. To address this issue we suggest that Ofgem re-calibrates upwards the incentive range for gas distribution

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?

See our general points above the principles of a symmetrical incentive rate and limited ex-post review are sensible and consistent with Ofgem's application of the IQI to date in gas distribution. However the key is that the rate has to be correct to start with we do not believe this is the case for the reasons outlined above. We believe Ofgem must make the suggested amendments to the indicative IQI matrix to preserve and strengthen the incentives on information accuracy and cost efficiency.

On the question of intergenerational impact it is difficult to make any fully considered comments without seeing any worked examples. Nevertheless it does seem that part of under/overspend deemed to be recovered from future generations (i.e. through RAV) will additional significant complexity to the calculation and reporting of the revenue adjustments. At this point we are still not clear how the adjustments under the present IQI will be calculated three years after the conclusion of GDPCR1. In any event it would be perverse if the application of this principle was out of line with the spit of fast and slow money.

Question 2: Do you agree with our proposed range for the efficiency incentive rate?

As per our comments above the range needs to be re-calibrated upwards for gas distribution.

Question 3: Do you agree with our proposed approach to the calibration of the IQI?

Again it is not clear what Ofgem is proposing here in line with our comments above we believe there are two key principles that must be applied:

- Companies forecasting costs in line with Ofgem's view of efficient costs or lower i.e. 100% or lower should get above base level return; and

- Companies that have achieved frontier performance and forecast continued frontier performance should receive greater rewards and less efficient companies should receive smaller rewards or face penalties.