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Dear Hannah

Response to Initial Assessment of RIIO-T1 Business Plans and Proportionate Treatment Consultation

Thank you for the opportunity to respond to the consultation on the proposed approach for fast-tracking the Transmission Network Operators' (TOs) business plans. Our response is from our perspective of a customer of the Transmission networks and of a network operator who will be subject to a RIIO price control in the guise of RIIO-ED1.

We are very pleased to see that a number of the developments introduced as part of DPCR5 have been included in the RIIO-T1 price control. It appears to us that the RIIO principles have encouraged the transmission companies to positively respond to the challenges; in particular the quality of plans produced and the level of visibility of those plans for customers and stakeholders is very much better than anything seen in previous reviews. In terms of Ofgem's assessment of those plans, it appears to be generally proportionate and balanced. It is inevitable that in the first implementation of RIIO price controls there will be a few areas where application of the principles falls a little short of ideal. I outline in this letter a few areas where we either disagree with the implementation basis or where we have insufficient transparency of processes undertaken to comment. The majority of our concerns relate to how Ofgem will bring the final packages together. Nonetheless, the fact that we identify a few concerns should not detract from the progress we have seen in the response of TOs to the future challenges for networks.

The move to the RIIO framework represents a significant development in the way that customers, companies and Ofgem agree business plans. Ofgem and customers must recognise that companies do not view parts of the plans in isolation and will always seek to propose balanced plans. As a result of this approach, companies may have some areas of their business plans which are viewed as frontier and some which are simply acceptable. If Ofgem or customers want companies to modify parts of the business plan, this may have some significant impacts on other areas of the plan especially in areas of risk, financeability or cost of equity. Ofgem should recognise that a 'sum of parts' analysis will not necessarily deliver a coherent proposition for customers, stakeholders and investors and risks "cherry picking" parts of different TOs' proposals which may not be deliverable.

It is very important that Ofgem demonstrates that there are benefits for network companies associated with achieving fast-track status. Whilst we accept that there may be some reputational and operational benefits (associated with contracting and management focus) to achieving fast-track status, Ofgem has not yet specified how it will incentivise investors and managers to aim for it. We remain concerned that if companies want to achieve fast-track status, they may adopt short term cost cutting approaches which may not be sustainable in the long term. This does not naturally sit well with the long term objectives of RIIO. We therefore ask Ofgem to ensure that the fast-track framework aligns with the long term nature of the networks and incentivises companies to bring forward innovative and efficient long term plans.

The first RIIO price control was always likely to highlight a number of issues which could be improved for the next series of price controls. In particular, it appears that insufficient time was available in the price control timetable to have sufficient discussions on key topics such as uncertainty mechanisms and annual price adjustments. The fast-track consultation approach illustrates how the companies need greater clarification of Ofgem's Well Justified Business Plan (WJBP) criteria. In a number of instances, the consultation does not provide any detail on *how* Ofgem made its decisions (eg its initial sweep and the results of the comparative benchmarking). It is important that customers and all network companies understand how Ofgem has made its decision to potentially fast-track companies. There are a number of examples within the consultation where Ofgem's ultimate decision can look somewhat at odds to the evidence in the detailed chapters. The RIIO regulatory principles recognise that the transparency and accountability of the decision-making process is important for both companies and the regulator at a time when the sector is undertaking a fundamental change.

The remaining parts of our response have been structured around the five summary Well Justified Business Plan criteria.

Process

Companies have an opportunity under the RIIO principles to submit targeted and proportionate business plans to Ofgem rather than the traditional business plans submitted in previous price controls. We are therefore concerned that despite all companies publishing "significantly more information than in any previous price control", Ofgem has marked most of its WJBP assessment categories as "need more information". To resolve this issue Ofgem must identify what type of information is required to make a decision on the robustness of business plans. This should be specified in advance in the WJBP criteria to allow companies to meet Ofgem's expectations for future price controls.

Ofgem's earlier communications on RIIO price controls suggested that companies could be subjected to differing levels of regulatory challenge (Tracks A, B or C depending on the quality of the business plan submissions and historic performance) with those companies in Track A potentially given fast-track status. We agreed with this approach as it assessed business plans as a package rather than a number of components. The approach described in the current consultation (with areas of the plan designated as red, amber or green) could result in any one company having some elements of their plan subject to proportionate treatment, some with a moderate level of scrutiny and some elements of a plan with intense review. Ofgem must recognise that companies make balanced decisions on plans (due to different local priorities or requirements) hence some elements may appear comparatively inferior in isolation compared to other plans with different objectives. The assessment should credit the overall package to avoid "cherry picking" and creating unacceptable overall packages.

Outputs

In DPCR5, we assisted in the development of an outputs framework to identify what companies will deliver for the revenue they receive from customers. We believe that this was a positive first step in discussing relative service levels and measuring delivery of our agreed obligations. We strongly support the ongoing development of output regulation and see the development of comparative output measures as the next big step in this journey. As truly comparable measures have not been developed for the T1 review, it will remain difficult to compare the effectiveness of TOs' plans using any "common currency".

We agree that companies should have specified and demonstrated environmental and innovation strategies within their business plans. It will be important that Ofgem recognises all facets of innovation including commercial, financial and innovative delivery in assessing plans. Without comparative output measures, it will be difficult for Ofgem to be confident that it has not inadvertently penalised innovative and efficient output delivery. For example, innovative co-scheduling leading to multiple outputs being solved by one input may result in a company's unit costs looking slightly higher but represents very efficient output delivery. Similarly, it is important to recognise that companies understand and discharge their various environmental responsibilities and consider how to achieve efficient compliance using alternative approaches.

Efficient expenditure

Part of the challenge for any future investment programme is how to demonstrate support for the achievement of the Government's carbon reduction targets. Furthermore, the WJBP criteria must recognise that plans under the RIIO framework are over a longer and more uncertain investment period than previous price controls. This will result in more much complex business plans which will be more reliant on uncertainty mechanisms than in previous price controls.

We are concerned that Ofgem has largely dismissed the increased work programmes required to ensure the connection of low carbon generation assets. Whilst we accept that any increases in costs and volumes will need to be fully substantiated, a default assumption from Ofgem that any cost increases are inappropriate could result in too much short termism and fail ure to deliver the Government's objectives.

Our stakeholder engagement approach adopted at DPCR5 provided a number of important lessons for future stakeholder engagement. The divergence of stakeholder opinions on environmental investments is significantly greater than on network reinforcement or asset replacement programmes. In areas where stakeholders disagree, network companies will always have to balance their views. We are concerned that there are some suggestions that where stakeholders' views differ to Ofgem's, stakeholders' views would be discounted eg on what proportion of linear assets should be undergrounded. The nature of regionally supported business plans may be at risk from this approach.

We agree that one of the key parts of assessing plans for future price controls will be the deliverability of future programmes and evidence of delivery at similar rates in previous price controls. In making this assessment, Ofgem must differentiate between those companies who have outperformed their previous settlements through innovative output delivery and those which have simply not delivered against their agreed output plans. One of the key benefits of a comparative outputs based price control settlement will be the facilitation of this assessment for future controls.

In addition to ensuring that they are comparing equivalent outputs, Ofgem must also ensure that costs and volumes are reported consistently across networks. Only through comparable output measures and robust cost and volume data can Ofgem confidently assess the relative efficiency of business plans. There is little comment in the consultation document on how this has been achieved.

Efficient financial costs

The RIIO financeability principles will be tested for the first time in the RIIO-T1 initial proposals. The evidence from submission and assessment of the transmission plans suggests that Ofgem's RIIO-T1 principles do not combine to form an acceptable package. Ofgem must demonstrate to customers, investors and stakeholders that its proposals will fulfill its statutory duty to ensure an efficient network company can finance its functions. The principles relating to cost of debt indexation, cost of equity and transaction costs must meet the efficient financial cost of a network company in the appropriate period. Ofgem has not included sufficient analysis in its consultation to support its views.

We are concerned that whilst Ofgem's policy on financeability has shifted, its traditional approach has not. Companies have demonstrated engagement with investor community and Ofgem has largely dismissed the evidence. Ofgem has not demonstrated that the companies' financeability proposals are holistically inefficient but has looked at individual components in isolation. When Ofgem attempts to construct an efficient, financeable plan, some of the policy positions may need to flex. In particular, we are disappointed to see that companies who proposed the use of alternative capitalisation percentages as means to ensure financeability have been penalised and had their proposals rejected without full consideration of the customer benefits. Capitalisation is the most efficient and cost neutral mechanism to resolve many financeability issues; we must review this financeability principle before RIIO-ED1 as it is currently having the effect of increasing prices paid by customers in both the short and long term.

Long term network investors (including pension funds) require consistent and predictable cash yields from their investments. The inclusion of equity metrics in the RIIO price controls (introduced as a result of the anti-equity criticism from investors) was to ensure that appropriate short and medium term returns were included in the packages. However, the absence of metrics that recognise cash dividends paid and the narrower focus on overall measures of RORE over an eight-year price review weaken this link. We understand why the transmission companies conducted financeability tests after removing minimum levels of dividends. Companies, investors and Ofgem need to work together on this issue to ensure that investors continue to provide sufficient finance to efficiently deliver the sizable network investment programmes required to deliver a low carbon economy.

We also have concerns about how the cost of equity is dealt with. Ofgem has published its preferred range based on its chosen analysis. However, as is evident by the weight of theoretical studies published, this is a subjective area with no single right answer. There is credible evidence supporting a range above that published by Ofgem, but even where a TO has limited its proposal to the upper end of Ofgem's range, this is rejected as not being "Well Justified". We consider that credible evidence for a point above Ofgem's range should be regarded as sufficient support for a proposal at the upper end of Ofgem's range; recognizing that a network company may be prepared to move away from an economically pure base case to make the overall package acceptable to Ofgem.

We are concerned that Ofgem's decision on the depreciation policy is likely, other factors remaining unchanged, to signal problems in later price control periods as a result of the inevitable decline in the FFO debt ratios (including those selected by Ofgem for testing financeability under the RIIO Principles). In considering financeability, Ofgem needs to take into account the effect of financeability issues in subsequent periods on financing costs in the period being assessed and the most efficient way of resolving long term financeability issues created by the change in policy.

Uncertainty and Risk

We are concerned that Ofgem and TOs do not appear to have had sufficient time to discuss and agree the approach to uncertainty in adequate detail to understand the key drivers or the proposed mechanisms. We need to learn from this in future price controls and ensure sufficient time is scheduled for such discussions. We have already discussed the importance of uncertainty mechanisms with the Ofgem team and all electricity networks recognise that this will be a particular issue for RIIO-ED1. We believe that there are two key dimensions to the level of uncertainty associated with decarbonisation of the networks: the volume uncertainty driven by customer take up of technology (including the associated UK Government incentive policy) and cost uncertainty driven by the application of embryonic technology and commercial solutions. A key challenge for all price controls is developing uncertainty mechanisms that appropriately allocate risk without removing the incentive on network companies to bring forward innovative solutions to new problems.

We suggest that Ofgem's policies concerning uncertainty and innovation need to be considered alongside each other and that any mechanisms introduced should not stifle innovation and efficiency.

We look forward to working with the Ofgem team to develop RIIO principles for the ED1 period. The experience of the T1 implementation will allow us to work together with Ofgem to build on these improvements to gain further benefits from RIIO price controls for customers, stakeholders and investors into the future.

I hope these comments are useful. Please contact me if I can be of any further assistance.

Yours sincerely,

Paul Bircham
Customer Strategy and Regulation Director