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23rd November 2012

Dear Hannah

Strategy Consultation for the RIIO-ED1 Electricity Distribution Price Control

National Grid's response to this consultation is informed from our participation in the RIIO-T1 price review for our UK electricity and gas transmission activities and our participation in RIIO-GD1 for our UK gas distribution activities. On this basis our comments on the RIIO-ED1 strategy are with respect to:

- the suitability and benefits of the overall RIIO approach from our viewpoint from having similarly regulated operations;
- our experiences on how the approach is applied and works in practice; and
- in particular, the need for linkages between the different network owners/operators in order to coordinate the transition to a secure and affordable UK low carbon economy.

Our views as a stakeholder of electricity distribution systems will, of course, be fed in to the relevant DNO stakeholder consultations.

The RIIO Approach

National Grid supports the RIIO approach to setting price controls. In particular, we welcome the opportunity to lead on the customer and stakeholder consultations that form the basis of our RIIO business plan and submissions. We suggest that there have been good examples under RIIO-T1 and RIIO-GD1 where the business lead has encouraged innovations in the identification of required outputs and the assessment and management of the risks associated with their delivery. This approach complements the strategic oversight provided by Ofgem and avoids drawing Ofgem into a micro-management role.

We also welcome the longer-term perspective for setting price controls and agree with the increase in duration to 8 years with separate setting of incentive exposures. For both RIIO-T1 and RIIO-GD1 the 8 year period spans a critical period from now until 2020 and key energy policy targets and so has facilitated the development and consideration of joined-up plans for this period. Longer-controls do give rise to more risks for companies and their customers due to external uncertainties and so a comprehensive consideration of risk allocations and uncertainty mechanisms is an essential part of this change. The models we developed to directly compare the impact of uncertainties under RIIO-T1 and RIIO-GD1 with their regulatory predecessors, which both received favourable feedback from our stakeholders, should be adaptable to consideration of the RIIO-ED1 changes.

Views from our RIIO experiences

Chapter 3: Incorporating stakeholder views

Question 1: Do you have any comments on our stakeholder engagement approach?
Question2: Do you have any views on how our engagement process or that of the DNOs could be made more effective?

We support the approach Ofgem proposes on stakeholder engagement. In order to address potential 'engagement overload' for stakeholders and ensure there is a consistent approach to general and societal issues we agree that it is important for Ofgem to play a role in ensuring stakeholders are familiar with policy developments and their high-level implications.

Where Ofgem leads on these issues we suggest the feedback from consumer groups that is relevant for companies is separated from other minutes that might be kept confidential.

A key issue for an effective engagement process is to ensure that Ofgem has sufficient resources to identify the stakeholder views and resulting actions that companies set out in their business plans. Given the wide range of issues, together with Ofgem's own role in leading policy related topics, there is a risk that company identified actions in these areas may be overlooked or given insufficient weight.

Chapter 4: Form and structure of the price control

Question 1 Do you have comments on the form and structure of the price control?
Question 2: Do you agree with our proposed changes to the RIIO-ED1 timetable?
Question 3: Do you have a view on the materiality of potential changes in allowed revenues/charges between price controls? Do you have any proposals to address this?

As noted above, we think there is good reason to extend price controls and the choice of 8 years for RIIO-T1 and RIIO-GD1. As electricity DNOs are likely to face equally demanding changes in key external drivers there is logic in making 8 years a default duration and using it provided that key uncertainties can be acceptably addressed by mechanisms within the control and through the mid-point output review.

As well as the transmission/distribution control overlap issues identified in the consultation document we would also highlight the importance of spreading price review work so that Ofgem can ensure they have sufficient internal resources for both the main and the mid-point output reviews.

On the fast-track facility, we support the principles in paragraph 4.13 of the consultation document and specifically that DNOs should not be allowed to revise elements of their plans once submitted. We think this should have been maintained for issues under RIIO-GD1 and the alternative approach taken there has removed a key area of differentiation between companies.

In making the assessment as to whether fast-tracking of particular plans is warranted it is important to distinguish between quality of the plans and their size or complexity. Given the group ownership of distribution licensees, it would also be helpful if Ofgem clarified whether it is companies or individual licensees that would be subject to fast-tracking.

Rather than risking an unmanageably long list of issues at initial proposals, Ofgem should ensure that policy issues that cannot be resolved before sight of the initial plans should nevertheless be resolved as soon after those submissions as possible and well in time for a second plan submission. Also, any 'draft proposals' published as late as the initial proposals document should have been subject to at least some initial discussions with companies to ensure practicality and consistency with the plans developed thus far.

Chapter 5: Ensuring output delivery

Question 1: Do you consider that the proposed outputs and associated incentive mechanisms, taken together with other elements of the price control, will ensure that companies deliver value for money for consumers, and play their role in delivering a sustainable energy sector?
Question 2: Do you consider that the proposed outputs and incentive arrangements are proportionate (eg do we have too many or too few)?
Question 3: Do you have any views on the proposed outputs and incentives?

We agree with the statements in Chapter 2 of the consultation document concerning managing the transition to a low carbon energy sector about the need for ongoing work in RIIO-ED1. As noted, the considerable uncertainty in how new technologies required to achieve the low carbon economy will be rolled out, how these will affect distribution businesses, and the nature of smart grid solutions that might be used to respond to future needs means industry wide thinking will be needed. Given the work already undertaken by transmission and gas distribution networks under their RIIO frameworks, we suggest there is scope and benefit for transmission and gas distribution representatives to participate in work streams considering pathways, scenarios and options.

In other areas where RIIO-T1 and RIIO-GD1 have established frameworks for describing, measuring and reporting similar outputs (for example, asset health measures) we suggest wider industry experience and involvement could help.

Chapter 6. Assessing efficient costs

Question 1: Is our proposed approach to cost assessment appropriate?
Question 2: Do you have views on our proposed use of proportionate treatment?
Question 3: Do you have any views on the criteria for assessing business plans?

We understand how a flexible “tool kit” approach is sensible to assessing RIIO-ED1 cost information, especially where companies may take different approaches to developing what they consider to be well-justified business plans and the finite nature of Ofgem’s resources. To facilitate use of tools in the tool kit, however, it is important that the required information is clearly specified. When we followed the guidance in the RIIO handbook in RIIO-GD1 we were informed that we had given too much detail. Subsequently, however, we were asked for information in supplementary questions that had already been provided (indicating that Ofgem had not had the resources to read fully the business plan information provided). Given that there are 14 DNOs, Ofgem should revisit the guidance on what detail they expect/require.

When Ofgem were considering which companies should be fast-tracked in RIIO-T1, work on various material issues common to all networks was suspended. More effective progress overall would have been achieved if the common issues were addressed first, leaving fast track companies to experience a lighter touch thereafter.

On benchmarking, we agree a variety of techniques should be considered in forming Ofgem’s view of efficient plans. Ofgem should use a bottom up approach to understand cost drivers, any regional factors and any material differences between company plans. However we are concerned that setting allowances using (in part) bottom up methods, without adequate consideration of the implicit risk of cherry-picking in this approach creates an unrealistic efficiency benchmark.

We fully support the principles in the RIIO framework that forecast plan benchmarking over eight years should be a key component in assessing networks comparative efficiency. Whilst this has not been implemented for RIIO-GD1, we believe that this could have been achieved and so certainly should be a part of the RIIO-ED1 approach to setting allowances. Ofgem’s proposals on the use of regional factors (Cost assessment appendix 10.3) looks like a policy position put ahead of such evidence. As part of this approach we also support early identification of high value projects which are then subject to a different assessment approach and separate output commitment. (For example, our proposed

London Medium Pressure mains replacement strategy in RIIO-GD1 should have been treated like this.)

In using disaggregated approaches in the tool-kit, Ofgem must be particularly careful that cost comparisons are sufficiently like for like (this is especially important where international comparisons are made).

<u>Chapter 7: Innovation</u>

Question 1: Do you have any views on the role of innovation in RIIO-EDI?
Question 2: What should the funding threshold for the Network Innovation Competition (NIC) be? Do you agree with our proposal to review it after two years to reflect learning from the LCN Fund?

While we accept that the NIC does not need to automatically follow a summation of the existing RIIO-T1 NIC and the current annual LCN funding limit, nevertheless it is important not to impose undue restrictions on innovation funding when such activities are particularly important. For this reason, and subject to emerging evidence and review, we would suggest the upper end of the £60-£90m range. A review after 2 years is sensible.

<u>Chapter 8: Managing Uncertainty</u>

Question 1: Do you have any views on the uncertainty mechanisms identified?
Question 2: Are there any additional uncertainty mechanisms required?
Question 3: Are there any mechanisms that we have included that are not necessary and why?

We agree with the high-level principles set out for the justification of uncertainty mechanisms. These are almost identical to those published in the RIIO-T1 strategy consultation on 17 December 2010. During the development of the 'Managing Risk and Uncertainty' Annexes that formed part of our business plan submissions, we completed a significant level of Monte Carlo analysis of the risks that we face. This allowed us to assess the effectiveness of the uncertainty mechanisms options that we were considering and also to estimate the impact that these mechanisms on our required cost of capital. The further development of techniques such as these is likely to be beneficial to both networks and Ofgem during the RIIO-ED1 process.

<u>Chapter 9: Financing efficient delivery</u>

We set out below short responses to the 3 specific questions that are contained in the RIIO-ED1 strategy consultation. We have not responded to the separate supporting financial issues document issued at the same time and the 23 questions within it as we have previously commented on most of these issues in our previous consultation responses on RPI-X@20, RIIO-T1 and RIIO-GD1, as well as in our RIIO-GD1 and RIIO-T1 business plans, and in our ongoing engagement and dialogue with Ofgem on RIIO-T1 and RIIO-GD1. We refer Ofgem to these for our views on these points.

Question 1: Do you consider that our proposed package of financial measures will enable required network expenditure to be effectively financed?

The efficient and effective financing of individual networks is the responsibility of the individual networks and their owners, and cannot be assured by the policy decisions on financial issues taken by the regulator. However, the treatment of financial issues can help to create the right incentives for networks to be efficiently financed, and if price controls do not provide sufficient revenues, or place too much risk on companies, efficient financing may not be possible and in some cases it may not be possible for networks to raise the funds that are needed to finance their investment and maintenance programmes. This would be to the detriment of consumers.

We have previously made known our reservations regarding some elements of Ofgem's approach to financeability under RIIO, both in our responses during the RPI-X@20 consultation process and through the RIIO-T1 and RIIO-GD1 price control reviews. Rather than repeating these concerns here we refer Ofgem to our previous communications, and merely note that in relation to the elements set out in paragraph 9.1:

- whilst it may be preferable in some circumstances to equalise incentives and align capitalisation with the actual split between operating and capital expenditures, this needs to be considered in the context of its impact on financeability and may not always be appropriate;
- similarly, setting asset lives for new assets to their expected economic lives has implications for financeability, on whether aggregate charges for consumers (over time) will be minimised, and on the intergenerational balance of charges, and as we have previously explained[1] may not always be appropriate;
- if a cost of debt index is to be used it needs to include all debt-related costs and not just ongoing interest costs. It should also include an appropriate allowance for the inflation risk premium, and needs to be appropriate in the context of the other elements of the financeability package – for example, if the package only achieves credit ratios that are BBB, the allowed cost of should be based on a trailing average of a BBB index only rather than an average of A and BBB indices;
- we agree that notional gearing, and also cost of equity, need to reflect the risks faced by a network under the proposed price control, and where companies have provided quantitative evidence of these risks this evidence should be given due regard;
- we note that under RIIO price controls, Ofgem intend notional gearing to reflect not just the assessment of a company's risk exposure, but also regulatory precedent and the range of RORE returns that may be achieved. However, notional gearing should not be used as a replacement for adequate incentives aligned to delivering customer's desired outputs. A company's actual gearing is not a particularly relevant factor given that price controls are set for the notional rather than actual company. In practice the requirement for credit ratios to have values under all plausible scenarios that are consistent with an investment grade rating, consistent with Ofgem's financing duty[2] but also helping to ensure that investments that are needed can be financed, will in many cases prove the main consideration;
- whilst it may be appropriate for companies to manage short term financing issues within their overall responsibility for financing their activities, it would not be appropriate for these to be addressed through provision of equity as stated in paragraph 9.1, when other alternatives such as a different profiling of revenues are available.

Question 2: Do you have any views on our proposed approach to assessing the cost of equity and the associated range of 6.0-7.2 per cent (real post-tax)?

At a high level, the proposed approach to assessing the cost of equity seems broadly reasonable, although the cost of equity cannot reasonably be assessed in isolation from a consideration of notional gearing and the level of risk or uncertainty in (notional) equity returns. These risks will be increased under RIIO, in part because of the longer duration of the price controls and the increased accountability of the networks for the delivery of outputs (which was one of the key objectives of RIIO).

For RIIO-ED1 it is likely to be reasonable to assess cost of equity using CAPM, cross-checked to evidence or estimates from other methods. We also agree that it is appropriate to base estimates of the input parameters for the CAPM estimate on longer-term rather than short-term estimates.

As noted in the response to question 3 below, the appropriate level of return on a real post-tax basis may be affected by any changes to the methodology used by ONS to calculate RPI.

[1] *See for example National Grid's responses to the RPI-X@20 consultations in January 2010, May 2010 and July 2010, to the RIIO-T1 Initial Strategy document, and to Ofgem's open letter consultation on the regulatory asset lives for electricity distribution assets (Ref 04/11).*

[2] *In performing its duties under both the Gas Act (Section 4AA(2)) and Electricity Act (Section 3A(2)), the Authority must have regard to the need to secure that licence holders are able to finance their activities which are subject to licence obligations.*

Question 3: Do you have any views on the other elements of our financeability proposals?

The answer to Chapter 9 Question 1 above provided our high level views on some elements of the financeability proposals. As that answer also explained, we have previously provided detailed responses to the RIIO financeability proposals both in our responses to the RPI-X@20 consultations and in our communications to Ofgem during the RIIO-T1 and RIIO-GD1 price control processes.

Paragraph 4.7 of the consultation makes reference to the current consultation by the ONS on RPI methodology. Both debt and equity investors in energy networks require a certain level of nominal returns on their investment: in the case of debt investors, coupon rates are generally expressed in nominal terms, and in the case of equity investors they require a level of nominal return which is competitive to the (risk-adjusted) nominal returns available from alternative investments in other industries and countries. The use of RPI is an intrinsic feature of RIIO price controls (and previously of RPI-X controls) which is used, amongst other things, to update allowed revenues during a control and to roll-forward the RAV from one year to the next. The use of RPI in this way provides one part of the overall nominal returns that are required by debt and equity investors in the networks, where the other element is the real allowed return that is set. If there are any changes to the ONS methodology for calculating RPI which changes its expected value, this will need to taken into account in setting the overall price control: if RPI on a new basis is lower than on the existing methodology, this will need to be taken into account by either setting a higher allowed real rate of return or by adding an uplift to RPI on the new basis before this is used to index allowed revenues and RAVs.

Links between network owners/operators and managing the transition to a low carbon economy

As noted in our answers to Ofgem's specific questions, managing the transition to a low carbon energy sector will need ongoing work in RIIO-ED1 with participation from all stakeholders including the transmission and gas distribution networks. In performing the role Ofgem identify for themselves in paragraph 2.10 of the consultation document we suggest that this should include the development of a strategic tool-kit comprising scenarios (building on those developed by the Smart Grid Forum), option value assessment methodologies, least regret assessments and other long-term assessments of sustainability issues as outlined in Ofgem's recent paper on decision making[3].

Yours sincerely

[By e-mail]

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[3] "Strengthening strategic and sustainability considerations in Ofgem decision making", July 2012