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Dear Mick,

National Grid Gas Transmission: Response to Ofgem's Consultation on a potential RIIO-T1 and GD1 mid-period review

National Grid Gas Transmission welcomes the opportunity to respond on whether there is a need to initiate a mid-period review in Gas Transmission.

Summary

We do not believe there are issues which need to be addressed through a mid-period review process on Gas Transmission. We believe there are some areas where confirmation of our understanding of how the RIIO principles would apply would be useful and we are committed to working with Ofgem to provide this further clarity to our stakeholders through our performance reporting and asset health methodology. We do not however, believe this clarity should be delivered through the mid-period review.

Purpose and Scope of a mid-period review

As background to the mid-period review, it is worth reflecting on the development of the RIIO framework and how it has been functioning to date. RIIO was established as an innovative framework which broke new ground in focusing on the outputs that network companies deliver for their customers rather than the inputs to achieve them. It set out a longer contract of eight years and a focus on total costs as opposed to focusing on particular opex or capex solutions to allow flexibility and stimulate innovation and new ways of delivering the outputs. In addition it places a greater emphasis on stakeholder engagement and customer satisfaction, including transparent and extensive annual reporting to stakeholders on outputs and performance.

Under the RIIO framework we have invested in business improvements to work more effectively for gas consumers. We are delivering the critical outputs for Gas Transmission of providing and operating a safe, reliable and sustainable network that allows customers to meet their energy needs. We have improved customer and stakeholder satisfaction levels and our environmental performance. In our opinion, the RIIO framework is incentivising behaviours that are in the interests of consumers. The framework, with its focus on outputs rather than inputs has led to a significant drive for innovation and finding new, more effective ways of delivering outputs over the longer time frame. For example, the eight year approach has enabled us to invest in long term changes to our operating model, such as the roll out of a business wide programme of process and performance excellence to drive a sustainable continuous improvement approach based on lean working and an end to end process approach. In addition, the framework incentivises the network companies to adapt their plans to ensure the best way of delivering outcomes for customers rather than be tied to pre-determined inputs.

It is important that these key principles of the eight year nature of RIIO are maintained in any consideration of a mid-period review and that the networks are incentivised to continue to deliver the right outcomes for customers. Therefore we agree there should be a strong hurdle of materiality for considering to review the RIIO framework at this stage and the risk of introducing uncertainty which might undermine long term value for consumers should be taken into account.

Q1 Do you have any views on the additional clarity we have provided on the RIIO-T1 MPR scope?

We have considered Ofgem's proposed revisions and clarifications to the scope of the mid-period review. RIIO-T1 Final Proposals defined the scope of the mid-period review to consider changes to outputs justified by clear changes in Government policy and new outputs required to meet the needs of consumers or other network users.

We note that Ofgem acknowledge the proposed mid-period review scope in this consultation has been widened to include items not expressly indicated in the Final Proposals specifically in relation to:

- a) the desire to provide further clarification of areas of policy that apply to output delivery; and
- b) widening the introduction of new outputs required to meet the needs of consumers or network users to changes to existing outputs (including outputs that are no longer required).

For scope change a), we concur that there may be merit in now clarifying how the RIIO framework will apply at the end of the eight year period. However, we do not think this should be in scope of a mid-period review and could be undertaken separately and made

transparent through ongoing performance reporting and guidance notes. As an example we will be reviewing and developing our Network Output Measures (NOMs) methodology. We believe this process should continue separately to any mid-period review. As based on our understanding from the experiences in gas distribution and electricity transmission, we are concerned that the timescales of a mid-period review would inhibit the industry developing the best methodology for consumers.

For scope change b), we appreciate the intent to provide symmetry in the consideration of output changes but we note this is a widened definition and not one that was within our reasonable expectations at the time of Final Proposals as being part of the scope of a mid-period review.

We think it is important to ensure a clear distinction between what outputs and outcomes we are committing to deliver and how we might deliver them. The scope of the review should not be reviewing whether a specific solution has been delivered but rather where the outcome is delivered, there is the clarity on the mechanism to share performance with customers and networks to preserve the incentive to do the right thing. This is one of the key principles of RIIO. We are concerned therefore that it appears throughout the mid-period review consultation for Gas Transmission there is a desire to review how outputs have or are planned to be delivered which we believe is clearly outside of the scope intended.

In addition, the RIIO framework is an eight year control with outputs largely defined as outcomes over that eight year period. We agree with Ofgem's desire not to create two four year price controls and hence the mid-period review process should not be used to adjust existing outputs or review how outputs are being delivered, particularly if some of those are still to be delivered (which is the case for all of the issues raised in the Gas Transmission scope).

Question 2: Do you consider the issues we have identified for RIIO-T1 in this consultation fall within this scope?

We do not agree that the issues raised with regard to Gas Transmission fall within the scope of a mid-period review. The areas discussed are not linked to any changes in Government policy and instead relate to the way in which outputs are being delivered not to changes in the outputs themselves. Whilst we agree that it would be useful to clarify how the RIIO rules apply to some of these areas we do not think this is part of the intended scope of the mid-period review and can be done through existing review mechanisms. The totex incentive mechanism which runs throughout RIIO was defined as a mechanism to share benefits and costs between consumers and network companies where outputs are delivered in different ways to that originally forecast. It would be useful if Ofgem could confirm this principle as we believe that it applies to the examples where outputs have been delivered in a different way. In addition, we are committed to ongoing development of the NOMs methodology to support greater transparency on asset health outputs.

The innovation tax relief issue covered in the cross sector issues section is not considered material for Gas Transmission (current assessment is impact of around £50k) and indeed our understanding is that this would be captured under an existing uncertainty mechanism around tax allowances

Question 3: Are there any other issues within the defined scope that we have not included when assessing the need for an MPR for RIIO-T1?

Our ongoing engagement with consumers and other stakeholders has not identified any areas that require new outputs at this stage, nor are we aware of any changes required to existing outputs justified by clear changes in Government policy. We have identified in the Annex that we intend to take forward additional work in developing our asset health methodology, but as we note this should be undertaken through the existing review mechanisms. The underlying asset condition is, as expected evolving as we gather more data and will differ from the modelled position that was used to determine the asset health outputs and hence through the methodology we will look to provide clarity on how risk will be prioritised and how this will impact on our asset health investment plans.

In addition, we are delivering more outputs in relation to European activities than envisaged at the time of Final Proposals (e.g. supporting PRISMA reporting requirements, impacts of EU code changes) however the current totex costs of these activities are not materially above base allowances.

Furthermore, we are seeing the changing future role of gas through renewable gas connection enquiries, the potential for shale gas developments, connections of installations to support gas for transport and potential hydrogen applications. We are also likely to see thriving UK transit flows as European markets continue to harmonise. Our network and services will continue to need to evolve to meet the changing requirements and indeed this is the focus of our recently approved Network Innovation Competition project CLoCC (Customer Low Cost Connections). However, at this stage we have not identified any matter that would be within the scope of the mid-period review.

We outline our specific answers to the detailed questions relating to Gas Transmission in the Annex.

I hope that you find this response useful. If you would like to clarify anything in our response please do not hesitate to let either myself or Richard Court (Richard.court@nationalgrid.com) know.

Yours Sincerely



Mark Ripley
Director, UK Regulation

Annex: Responses to specific Questions relating to Section 3: Gas Transmission

Question 13: Based on our current assessment there may be some issues in Gas Transmission that could be addressed through an MPR. Do you agree with this assessment?

We do not agree that the issues raised with regard to Gas Transmission fall within the scope of a mid-period review. The areas discussed are not linked to any changes in Government policy and are not new outputs. They relate to the way in which outputs are being delivered and, whilst we agree that it would be useful to clarify how the RIIO rules apply to some of these areas we do not think this is part of the scope of the mid-period review set out in the Final Proposals and should be done through existing review mechanisms. The totex incentive mechanism which runs throughout RIIO was defined as a mechanism to share benefits and costs between consumers and network companies where outputs are delivered in different ways to that originally forecast. It would be useful if Ofgem could confirm its application to the examples where outputs have been delivered in a different way (which is the case for all of the issues raised in the Gas Transmission scope). In addition, we are committed to ongoing development of the NOMs methodology to support greater transparency on asset health outputs.

Question 14: We are considering undertaking a review of the requirement and associated output to deliver an Avonmouth pipeline solution. Do you agree with this?

At the time of our RIIO-T1 submission our assessments indicated that to meet the output of managing the reduction in capability associated with the Avonmouth LNG facility closure, the best solution was to build two pipelines. In Final Proposals a baseline allowance was set based on this solution and an output defined as a pipeline solution.

This has created some confusion however, as we believe in this case the actual output required by network users and consumers is to effectively manage the consequences in terms of Operating Margins and capacity reduction from the decommissioning of the Avonmouth LNG facility.

To that end, and as per the RIIO principles we have sought the best way to deliver that output that is in the interests of the UK consumer.

We fully investigated asset and operational solutions and also carried out stakeholder discussion with the Health and Safety Executive (HSE) and Wales and West Utilities, the distribution network operator. Through these discussions and the studies we undertook, we gained a better understanding of the distribution network characteristics and the associated overall network needs. This enabled us to develop the As Low As Reasonably Practicable (ALARP) assessment for the Operating Margins requirement, resulting in the identification of an alternative, more cost effective approach. That alternative approach, which was accepted by the HSE, negated the need to build a pipeline to cover the loss in Operating Margins capability. In addition, based on our most current view of capacity requirements in the South

West, although we will be carrying increased risk without the Avonmouth LNG facility, we determined that the needs case is not sufficient to undertake a new pipeline build. Therefore the needs case does not exist to build either pipeline at this point.

If gas demand in the South West does not grow and hence we do not build the pipelines to cover the increase in capacity risk, in the remaining part of RIIO-T1, approximately £92m (09/10 prices) will be returned to consumers. We believe this is an example of the RIIO principles working effectively, with the totex incentive mechanism aligning the interests of consumers and network operators.

In summary we believe delivering the defined output of a pipeline solution, based on the work done since Final Proposals, would not be in the interest of consumers. We believe this example demonstrates the need to ensure that output measures reflect the actual needs of network users and consumers and avoids specifying physical solutions that could influence the actions of network operators to the detriment of consumers.

We have reported our decision and the process we have followed within our Regulatory Reporting Pack Submissions and have also presented our approach to Ofgem, answering all associated questions.

Given the outcome of operating the network safely and efficiently without Avonmouth remains an enduring output to manage for the remainder of the RIIO-T1 period, we will need to continue to monitor, assess and manage the local needs and demands of the South West region of the network. To this end, we do not feel a mid-period review of this outputs is warranted.

Question 15: We are considering reviewing how National Grid Gas Transmission (NGGT) is meeting its output to maintain its 1-in-20 obligation for Scotland. Do you agree with this?

The requirement to maintain 1-in-20 compliance in Scotland in response to changing flow patterns still exists, and we are investigating the best way to meet the output. We have already defined an asset build solution, however we are investigating if there are other innovative solutions that may be more cost effective, which is a key principle of the RIIO totex incentive approach. This involves a collaborative exercise with Scotia Gas Networks, where we are assessing if there is an optimal distribution/transmission solution that better meets the need. Once this exercise is concluded, anticipated May 2016, we will progress with the solution that is in the best interests of consumers and meets the output of maintaining 1-in-20 compliance in Scotland.

We do not see any benefit in reviewing this output at the mid-period review, as the output is still relevant.

Question 16: We are considering reviewing how NGGT is meeting its output to deliver specific compressor projects. Do you agree with this?

In response to the Industrial Emissions directive (IED) baseline funding has been provided for Integrated Pollution and Prevention Control (IPPC) works at Peterborough and Huntingdon and Large Combustion Plant (LCP) works at Aylesbury.

The actual and specified output in Final Proposals at Peterborough and Huntingdon is to deliver emissions reduction at these sites, in agreement with the environmental agencies that complies with the requirements under IPPC. Ofgem specified a particular unit size and drive type to create an allowance. However the actual drive and engine size is determined by a Best Available Technology (BAT) assessment, as obligated by the environmental agencies, and the overall network capability requirements for the station as a whole. It is also dependent on the products available from the market.

In the case of Peterborough and Huntingdon the application of BAT resulted in a decision to install smaller, gas units, compared to the allowance for 24MW electric units. However, as part of Final Proposals in the unit cost allowances provided by Ofgem, funding was not provided for exceptional costs e.g. land purchase, relocation of vent stack and replacement of control building. Therefore the actual difference between the baseline allowance provided and the current forecast costs is not material.

It should also be noted that Final Proposals did not state that the allowance would be adjusted by the size and type of unit installed. This would be a new arrangement more akin to an uncertainty mechanism, such as a revenue driver, rather than baseline funding. This approach could be worth considering for the future, assuming it is symmetrical, but risks incentivising the wrong behaviour and discouraging innovation and therefore would require detailed evaluation.

In terms of Aylesbury, this falls under the LCP element of IED and requires us to reduce emissions of CO and NOx to specific levels. To do this our best view at the time of the RIIO-T1 submission was that we would need to replace both of the existing units. As the project moved into development, we reviewed all strategic options and identified a potential novel solution of using an oxidation catalyst. After further research and discussions with the OEM and catalyst manufacturer this was selected as the preferred solution. We anticipate completing these innovative works by mid 2016.

In our opinion this is another great example of the RIIO principles working and we have publicised this in a number of external communications. The actual and specified output is to deliver compliance at Aylesbury with LCP, which will be achieved by a novel approach delivering significant savings to the consumer, in the region of £30m (09/10 prices).

Based on the above we do not see any benefit in reviewing this output at the mid-period review.

Evaluation of low utilisation sites which can opt for the “500 hours derogation”

An application on which units to enter into the 500 hour derogation was made to the environmental agencies in December 2015, as required by the IED Legislation, following extensive stakeholder engagement. As part of the May 2015 reopener, we detailed data to support our proposed decisions and also engaged in question and answer sessions with Ofgem. Any further review of this information, now that the decision has been made and cannot be reversed would not seem beneficial, particularly as part of any mid-period review.

Network Output Measures (NOMs)

In the consultation, Ofgem propose not to review the NOMs methodology for Gas Transmission as part of a mid-period review process. We agree with this approach as there is an existing process to do this and we are committed to fundamentally reviewing our methodology in consultation with stakeholders during 2016/17. One of the specific aims of the fundamental review will be to introduce a trading mechanism between asset categories.

In the first years of RIIO-T1, further asset health condition assessments are identifying that the underlying condition of our asset base is different from the modelled position within our RIIO-T1 submission. Therefore as part of our methodology review, we will engage with stakeholders to explain our asset health prioritisation approach and the impact this may have on our plans across our main asset categories.

Summary

In summary for Gas Transmission we do not see a need to undertake a mid-period review as we believe the RIIO framework is driving the right behaviour and delivering significant consumer benefit. We are concerned with any potential position with regard to linking outcomes to physical solutions. This approach could drive the wrong behaviour by reducing the incentive to deliver innovative solutions that benefit consumers. Therefore clarity around output delivery that is consistent with the RIIO principles may be useful.

Section 6: Cross Sector Issues

Q20: Do you agree that we should clarify some areas where it isn't clear how late or non-delivery will be treated? If so, which areas do you consider would benefit from such clarification?

We agree it would be useful to clarify how late or non-delivery of outputs might be treated at the end of the eight year Price Control. Whilst we do not think this should be part of the intended mid-period review scope, we are committed to ongoing working with Ofgem to bring this clarity to our performance reporting forecasts and through our network outputs measures methodology,

Q21: How material do you consider innovation tax relief has been and is likely to be for the network companies? Do you consider this is an issue that we need to pursue as part of any MPR? We request that network companies provide estimates of the benefits accrued so far due to this tax relief as part of their response?

We do not consider innovation tax relief to be an issue that needs to be reviewed as part of the mid period review. There is no need for corporation tax matters to go through the mid period review because there are existing uncertainty mechanisms in the RIIO framework that already adjust our tax allowances under a range of circumstances including, but not limited to, changes in legislation or HRMC interpretation. These are covered by the tax trigger uncertainty mechanism.

In addition, we do not consider this item to be in scope of a mid-period review as whether or not HRMC interpretation can be considered a Government change, there has not been a change in outputs.

Notwithstanding our views on the validity of being in scope for the mid-period review, we have set out below the estimated tax reduction benefits that we will achieve per annum. It should be noted that expenditure within the "innovation stimulus", due to the specific tax rules, may not qualify for enhanced tax reliefs. For the RIIO-T1 period to date, the expected permanent tax benefit for "innovation stimulus spending" for Gas Transmission is expected to be a reduction in tax payable of circa £50k. This is not considered material and there is no expectation that there will be any significant change to this benefit going forward. We do believe it is appropriate for networks to make appropriate claims if the expenditure is eligible for the enhanced reliefs.

