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4<sup>th</sup> September 2017

Dear Jonathan,

### **Open Letter on the RIIO-2 Framework**

We welcome the opportunity to provide our views on the current RIIO framework as Ofgem considers the appropriate regulatory framework for the future. RIIO started in 2013 and introduced a number of changes from the previous regime, and we believe this has worked well for consumers and the wider stakeholder community.

We believe RIIO has broadly achieved the original objectives set out, as demonstrated by some key outcomes;

- Consumers are receiving a further improved service and at lower cost than prior to the start of GD1
- Stakeholders are at the heart of our businesses, with outcomes achieved in line with their expectations
- Consumers are benefitting from the significant innovation undertaken by the companies - and are clearly sharing in the outperformance companies are delivering
- We have increased the focus and support given to the most vulnerable and those in fuel poverty across our operating region
- Investor confidence in these businesses continues to reflect the predictable and well understood regulatory environment

The process of reviewing the RPI-X framework between 2008 and 2010 was a transparent and open process, and one with which many diverse stakeholders were engaged. The subsequent RIIO framework is held up by many around the world as the model for regulated monopolies. Whilst only four years old, RIIO has already provided a positive focus for networks, and demonstrated real benefits for consumers. There are some beneficial refinements that could be made for GD2, but, by and large it is working well.

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The energy sector is going through significant change as it adapts to the 'trilemma' challenges of affordability, security of supply and carbon reduction. Against this background, much research is taking place around future energy options. We have carried out some ground breaking and independently verified work, these include:-

- **Bridgend Study**<sup>1</sup> – The only complete objective review of all existing heat technologies in actual homes
- **Cornwall Energy Island**<sup>2</sup> – The only energy simulator to look at daily/hourly energy balancing for an actual region using actual data
- **Freedom project**<sup>3</sup> – The first real pilot of Hybrid heating technologies with smart controls in real homes – many of which are in fuel poverty
- **Integrated Energy System Model**<sup>4</sup> – building on the Cornwall Energy Simulator but available for any town, city, county or country to be modelled

We believe, that in all credible scenarios, there is an important place for gas and the gas networks; whatever the nature of the gas flowing through the pipes. With this in mind, RIIO 2, including GD2 will be an important price control period as we define the vital contribution the gas networks make to this lower carbon future.

Some interesting developments are already taking place regarding 'green gas'. For example, we have already connected 16 Biomethane plants to our network, with the capacity to supply heat to almost 112,000 homes. Interestingly, this is already more than twice the energy projected by the Swansea Bay Tidal Lagoon, at a fraction of the cost.

We have also connected 20 gas fired peak electricity generation plants in the past couple of years, with hundreds more enquiries. These local plants clearly help support the intermittency of renewable solar, wind and tidal generation. With more than 80% of peak heat and power demand met by the gas network, communities will continue to rely on the gas networks to keep the lights on and power industry in addition to low cost, secure and low carbon heat.

We are also now seeing developments in the use of gas in the transport arena, with several buses being fuelled by gas. A good example of this is the recent announcement by South Gloucestershire Council to introduce 110 gas buses for services around Bristol.

<sup>1</sup> <http://www.smarternetworks.org/Project.aspx?ProjectID=1769#downloads>

<sup>2</sup> <http://www.smarternetworks.org/Project.aspx?ProjectID=1873>

<sup>3</sup> <http://www.smarternetworks.org/Project.aspx?ProjectID=1978>

<sup>4</sup> <http://www.smarternetworks.org/Project.aspx?ProjectID=1997#downloads>

When consulting our stakeholders during August 2017 about the RIIO 2 framework review and the implications, they provided the following feedback:

- Meeting future demand is rated as their highest priority from 2021 onwards, closely followed by a low carbon future; recognising their support for gas well into the future
- almost 90% of those consulted support the need to invest to meet future energy needs
- almost 90% state that our existing bill is value for money; demonstrating that RIIO is delivering value for money
- Around 70% of our stakeholders support a mechanism of sharing outperformance and overspends with the consumer; indicating this is a fair incentive

Our detailed response to the questions outlined in your Open Letter is attached and I have briefly summarised our views below;

- **Consumer Bills** - charges for WWU consumers have fallen to £128 a year in 2016/17 from £145 in 2013/14, a 12% reduction. A clear indicator that RIIO is working well
- **Outputs** - we believe these are working well and are driving significant improvements, especially in terms of customer satisfaction and reduction in network costs. We would welcome an increased future focus on 'outcomes' for the consumer/stakeholder, and the refining of Outputs such as customer interruptions and Network Output Measures
- **Incentives** - we believe these are broadly appropriate and are benefitting consumers and networks. However, there are some new incentives that we would advocate, for example incentivising 'Green Gas' connections as well as the flexibility and storage provided by the gas networks
- **Innovation stimulus** - in our view this has driven significant change to a culture of real innovation across energy networks. It has also been hugely successful in engaging hundreds of SME's with networks, who have brought real innovation and entrepreneurial outlook to the sector
- **Revenue** - we strongly believe that efficient networks should be able to achieve appropriate levels of outperformance

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- **Financeability** - it is critical to ensure an ongoing stable and predictable environment for debt and equity investors, particularly given that UK energy companies compete globally for funding
- **RORE** - we believe the current measure is incomplete and somewhat misleading, given it takes no account, for example, of actual performance against the cost of debt allowance
- **Sharing mechanisms** - this has worked well for consumers, and should continue with an appropriate sharing of risk and reward
- **Engagement** - feedback suggests our stakeholders have been fully engaged with decision making within our business during GD1, and we agree this approach should continue
- **Length of price control** - we believe there have been real consumer and investor benefits of a longer eight year control in controlling external costs. However, we also recognise the arguments for reverting to a five year control period. We would welcome the establishment of a working group to consider this further
- **Business Plan** - we would welcome a common format or template to simplify business plans, and make them more easily comparable and transparent to external stakeholders
- **Asset stranding** - we believe we can clearly demonstrate that gas is a low cost, no regrets energy option for consumers, and there is subsequently no risk of asset stranding in the coming years

We look forward to working with you and your team to develop the RIIO 2 framework further.

Yours sincerely



**Steve Edwards**  
Director of Regulation and Commercial

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**Detailed Response to Ofgem Open Letter on RIIO 2 Framework**

**Principle 1 – Giving consumers a stronger voice in setting outputs, shaping and assessing business plans (Q1-8)**

**1. Do you agree with our overarching objective for RIIO-2 and how we propose to achieve it?**

We welcome this review and agree with the overarching objective of RIIO-2 which ensures regulated network companies deliver the value for money services that consumers want and need. Learning from RIIO GD1, we agree that stakeholders should have a strong voice in the setting of the price control and we commit to delivering this as part of our RIIO GD2 Business Plan.

Gas and Electricity networks are clearly changing; becoming integrated to enable renewables. The regulatory regime will need to respond to this in delivering the needs of the future consumer; decarbonising heat, power and transport without excessive cost.

We also agree that investors should be able to earn returns that are fair, reflecting the appropriate level of risk whilst also encouraging investment in the sector. In addition, regulated companies should be appropriately incentivised and innovative to deliver the lowest cost solution to the UK's energy trilemma.

**2. How can we strengthen the consumer voice (primarily end-consumers), in the development of business plans and price control decisions?**

We welcome the increased focus on engagement and it has matured during this first RIIO period. We agree that looking at best practice across different industries is valuable to enhance the voice of a wide range of stakeholders but would also seek more structured sharing of best practice between networks.

We recommend the use of technology (such as apps, media tools, polls etc) to encourage wider engagement and reach more stakeholders, such as the customer facing app we have in WWU which provides immediate customer feedback which we can act on straight away. We recognise the need for a variety of engagement techniques to ensure a wide range of stakeholders are consulted, particularly hard to reach consumers, those in fuel poverty and future bill payers. In addition, in a post Brexit economy, business consumers will need a competitive and secure energy source – it is important we hear

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their views in developing our price controls. We would also support strengthening the 'Willingness to Pay' research to ensure companies are delivering value for money.

In the development of the business plans, we would also welcome the opportunity to undertake engagement jointly with Ofgem and the other network companies where appropriate, to ensure an aligned and joined up approach.

### **3. How should we support network companies in maintaining engagement with consumers throughout the price control period?**

The RIIO-GD1 Stakeholder Engagement Incentive has encouraged greater engagement throughout price control periods. This has promoted the sharing of best practice as well as more collaborative engagement.

We suggest that the incentive is developed to promote broader and deeper engagement and includes an effective evaluation framework which incorporates reviews of stakeholder activity 'in-situ', seeking direct input from stakeholder and stakeholder groups. We would also suggest that methods of measurement and quality control are agreed as part of RIIO GD2. We are keen to work collaboratively with Ofgem and other networks in this area.

### **4. Does this structured approach to defining outputs provide the right level of clarity around delivery?**

Consumers have benefitted from the Outputs in RIIO GD1 demonstrating that the structured approach is working and is required going forward. We agree that Outputs need to be clearly defined and targeted at the right behaviours and decision making. Outputs also need to be measurable and have targets that are equally challenging for networks within a sector.

We agree that Outputs need to be well thought through, clearly defined, targeted at the right behaviour and widely consulted upon to avoid unintended consequences. Outputs also need to be measurable and have targets that are equally challenging for all regulated companies within a sector.

The "Output workgroups" in RIIO-GD1 worked well and a similar approach for RIIO-2 is appropriate. However, one key learning point is not to rush new Outputs into the final proposals without the appropriate time to allow reflection and relative comparisons of challenge for all networks.

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## 5. How can the outputs framework be improved, including the introduction of additional output categories for example around efficient system operation for distribution network companies?

Outputs should be driven by the feedback we get from our stakeholders and focus on the required 'outcome' to the consumer. We would welcome a review of how we can develop the linkages between Totex costs and Outputs.

In addition, we would recommend new Outputs and incentives which further promote the use of green gases, flexibility and demand side management across the gas network (Transmission and Distribution). For example, we have connected 16 Biomethane sites and there are currently no suitable Outputs or incentives to promote this or help recognise activity, even though it is in the interest of the UK in helping resolve the energy trilemma. Further consideration should be given to Outputs which optimise between electricity and gas distribution given the integrated nature of the networks.

Where there is sufficient stakeholder support and the ability to set appropriate allowances, then regional specific Outputs and incentives may also have a role to play. There are three specific areas that could be improved from RIIO GD1:-

- Interruption Outputs – We suggest that targets are not equally challenging for all networks
- The Network Operating Measures – We are still defining these four years into RIIO GD1
- Customer Service – We think that there are opportunities to broaden this to a wider customer base and also to use improved smarter technology to support greater reach

## 6. Did the outputs target the right behaviours?

The RIIO-GD1 Outputs are driving the right behaviours within gas distribution. We are in broad agreement with the recommendations and conclusions of Ofgem's Mid-Period Review work, as the conclusions deliver consumer benefits.

By linking cost allowances and incentives to Outputs, there is clear focus on those Outputs from networks. The focus on outcomes as opposed to "inputs" drives innovation, and provides networks with the flexibility to drive least Totex cost solutions.

As highlighted above there are some Output areas that may need further development ahead of RIIO-2 and we are keen to work with Ofgem and other stakeholders to develop this thinking further.

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## **7. How can we address areas of expenditure for which a clear output is difficult to define?**

A sensible start point would be to understand the scale of any gaps for each of the sectors. There are likely to be different issues within each sector. In gas distribution, a significant amount of our costs are covered by Outputs, however a shift towards achievement of broader outcomes such as decarbonisation would be worthy of consideration.

There is an established gas distribution cost and output workgroup to help drive this area forward, and we would support a process that aims to understand the scale of any issue. We would also look to approach our stakeholders to help us address any such gaps.

## **8. Were the output targets and associated financial incentives set for RIIO-1 appropriate, reflecting what consumers value and are willing to pay for?**

We broadly agree that they do reflect what consumers value, and we support similar principles in RIIO-2, informed by stakeholders. Consumers consistently want 'more for less' and GD1 has delivered that, especially in areas such as Reliability, Safety and Environment. The Output targets have proved stretching for all GDN's, but we have risen to the challenge and are delivering 'more for less'.

We will continue to engage with our stakeholders to ensure alignment.

**Principle 2 - Allowing regulated companies to earn returns that are fair and represent good value for consumers, properly reflecting the risks faced in these businesses and prevailing financial market conditions; (Q9-15)**

## **9. What changes in the RIIO framework would facilitate returns that are demonstrably good value for consumers?**

We believe it is in the long-term interests of consumers and investors that efficiently incurred costs of capital are compensated in a transparent way supported by improved reporting - in particular a more accurate representation of RORE. We would encourage Ofgem to review the RORE calculation. Furthermore, we believe Ofgem should introduce a new measure focusing on return on total capital employed, not just equity.

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RIIO-GD1 is generally working well. The current framework ensures outperformance from effective and efficient investment is shared with the consumer and earlier than was the case in previous controls.

The symmetrical revenue incentives within the RIIO-GD1 sector are benefitting consumers, to the extent savings are passed on by Shippers. For example, WWU has already returned over £21m to shippers as part of the fast money outperformance to date through the annual sharing mechanism, and we are forecasting a further £25m through the second half of RIIO-GD1.

Our answers to some of the questions that follow indicate further potential for improvement.

#### **10. How can we minimise the scope for forecasting errors?**

We would encourage Ofgem to review the scope for assessment of forecasting “errors” and to consider the impact of volatility in non-controllable costs. This is an area where significant volatility to reported profit and cash flow can, and has, arisen which is not in the long-term interests of investors or consumers.

Forecasting errors for total costs (including costs of capital, non-controllable costs, taxation etc.) for any single network is inevitable, because such costs cannot be predicted with absolute certainty when revenue allowances are set for any future control period.

We do not believe there is much potential to reduce forecasting error beyond an appropriate assessment of efficient cost in each area of business activity and capital deployed. Such efficient costs, because of their nature, will remain volatile. The efficacy of regulatory management and control should not be affected to any material degree by moderate forecasting errors, provided allowances are set based on an appropriate assessment of efficient costs.

Reducing the term of the control period may lead to a reduction of forecasting error, but creates other issues, such as the potential for increased regulatory risk that may be perceived by investors and higher costs through reduced contract negotiating power.

#### **11. What constitutes a fair return for a regulated monopoly network company, and how can we ensure that returns remain legitimate in the eyes of stakeholders?**

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A fair return should be founded on basic principles of efficient cost and a thorough, balanced assessment of risk.

As Ofgem has noted in its recently published strategy<sup>5</sup>, “the gas market is going through a period of change”, and “managing this uncertainty will be an important aspect to development of the RIIO-2 framework”. We believe that a fair return for investors must take full account of these important matters.

Legitimacy should be a matter for all stakeholders, including investors and consumers. Legitimacy can be supported if there is a clear link between returns and outcomes delivered. The RIIO framework for Totex is set up to achieve this outcome in this regard and WWU, as a top performing network, is a good example of that balance.

Measurement and communication are important. Therefore, measures of return should reflect actual performance and be reported on in a timely basis with appropriate explanations.

## **12. What factors do you think are relevant for assessing and setting the cost of capital so it properly reflects the risks faced by companies?**

We believe that setting an appropriate allowance for the cost of equity requires considerable judgement given the risks to equity capital, and that this area should be very carefully considered. We do not believe that the same equity allowance in terms of a return percentage of RAV should necessarily be applied to each regulated company, due to differences in business and financial risks.

We believe the methodology for the cost of debt could be improved, and we welcome the opportunity for its review. The current Iboxx 10 year trailing average for gas distribution has significant issues, particularly since it does not match the timeframe over which we raise debt.

## **13. Can we improve our methods for the indexation of the costs of debt and equity?**

We agree that improvements can be made.

Please refer to our response to question 12 above. In summary, the cost of capital must properly reflect the risks we face and be based on current market indices.

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<sup>5</sup> <https://www.ofgem.gov.uk/publications-and-updates/ofgem-s-new-strategy-regulating-future-energy-system>

**14. Are there specific amendments to any core aspects of financeability that we should be considering in light of performance during RII0-1 and the change in the financial environment?**

We would encourage Ofgem to review the licence conditions governing the regulatory “ring fence” to assess areas which could be improved. We believe improvements can be made which would underpin the integrity of the regulatory ring fence measures, such as improved clarity on definitions.

**15. Should we consider moving to CPIH (or another inflation index) and how should we put into effect any change to ensure it is present value neutral for investors?**

We believe this should be considered. However, it should be acknowledged that existing equity and debt investors have committed capital to a regulated business which was, at that time, RPI indexed. Consequently, any change to another index must be assessed and managed with caution.

Any justification for moving to another price index should be established well in advance of the next control period, and be subject to an open and extensive consultation, including feedback from investors and rating agencies.

Any change from RPI to any other price index must be present value neutral to investors, and we are pleased to see this important point acknowledged in the question. The mechanism to achieve that neutrality should be transparent and credible. Any change should be phased over an appropriate timeframe. Failure to meet these conditions would likely increase the cost of capital and ultimately be adverse to consumers’ interests.

**Principle 3 - Incentivising companies to drive consumer value by shaping or proactively responding to changes in how networks are used and services are delivered; (Q16-21)**

**16. Do you think there are sufficient benefits in aligning the electricity price controls to off-set the disadvantages we have outlined?**

The price control process dictates the investments that will underpin the drive to a smarter, more flexible network future. That future includes transmission and distribution. Aligning the electricity price controls appears to be a sensible step that would support the broader energy challenges. We highlight below further options that reflect our view of the energy system development.

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## 17. Are there any other realignment options we should consider?

The energy system is changing, including the;

- drive for a smarter, more flexible integrated energy system,
- rapid change and take up of renewable energy (gas and electricity),
- new and changing users of energy networks, such as small peaking gas plants and green gas producers,
- future growth in electric and gas vehicles,
- potential for hybrid heat and power appliances in the home and industrial sites,
- lack of alternatives to inter seasonal storage or sufficient flexibility to support weather dependent and intermittent electricity generation, and
- A high possibility of further localised generation and use of energy.

It therefore appears sensible to align all price controls at some future point to ensure energy system investments provide the best value for energy consumers across the wider integrated energy network. However, we understand the practicalities of such a move to align all price controls, and therefore suggest this move could be completed in stages.

## 18. What amendments to the RIIO framework, if any, should we consider in supporting companies to make full use of smart alternatives to traditional network investment?

The existing RIIO-GD1 framework and commercial arrangements (mostly via the Uniform Network Code) for gas distribution already support the use of smart alternatives. However, as requirements evolve there may be opportunities to further develop both the RIIO-GD1 framework and industry's commercial arrangements.

To maximise value and minimise costs to consumers there are already a number of flexible options to identify an efficient outcome.

- **Demand Side Management.** This is a feature of the gas distribution sector already and has been for a number of years. The commercial arrangements were updated prior to RIIO-GD1. We have had contracts within the last 3 years providing this option
- **Storage and system flexibility.** The gas distribution and transmission network currently provides the large scale storage and flexibility for heat and electricity that no other energy vector can – including batteries.

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We agree that there may be opportunities for further development, and some early thoughts include;

- Updated Outputs for gas distribution. Currently there are limited Outputs (a 1 in 20 obligation) linked to the valuable storage and flexible role the gas distribution network plays.
- Review of options between Gas Transmission and Gas Distribution. There may be the opportunity to explore the opportunities for a more joined up approach during the RIIO-2 process. This may lead to assessment of investment/allowances for certain growth options at this joined up level.
- Storage is the key to decarbonisation, not just short-term storage and flexibility for electricity, but medium and long term energy to avoid excessive cost of generation/interconnection and to provide security of supply in a future uncertain world. Unlocking smart alternatives and enabling them will be key for both gas and electricity distribution. This includes smart hybrid technology that is responsive to the hour by hour requirements of supply, demand and capacity.
- Stakeholder engagement. Our unique energy simulator has already highlighted to us and our stakeholders the importance of an integrated energy system; combining gas & electricity. We will therefore work with all network operators (gas & electricity) as we develop our RIIO-2 plan.
- We are already collectively working on unique and ground breaking hybrid heat systems in the “Freedom Project” with our local electricity distribution network, Western Power Distribution. Hybrid heating may well be a key energy efficiency and demand side response solution for homes and business to decarbonise energy affordably.
- Uniform Network Code and other commercial arrangements. We will engage with a range of stakeholders to take this forward during our own RIIO-2 engagement processes and would seek the opportunity to work collaboratively at a national level.
- Energy efficiency. There are no specific gas distribution Outputs that focus on this, and this is an area that we may be well placed to work with our partners to help consumers (domestic and commercial) improve energy efficiency. We will explore this as part of our own review of RIIO Outputs.

**19. Given the uncertainty around demand for network services, how much of an issue might asset stranding be and how should this risk be dealt with?**

We acknowledge that the energy system is changing and is becoming more integrated. However, we cannot see asset stranding in gas distribution as an issue due to the continued reliance on gas in the energy system well into the future.

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Despite uncertainty in terms of the scale of renewable electricity generation and electric vehicle take up, there is future certainty driving continued use of gas distribution networks;

- gas is one of the lowest carbon, most secure and lowest cost domestic heating solutions
- 85% of homes use gas for heating homes
- circa 50% of power comes from gas, increasing to 80% at peak times
- at peak times the gas network transports 8 times the energy of the electricity network
- we already have 16 biomethane connections that can heat 112,000 homes from green gas. This is already more than twice the energy projected to be delivered by the Swansea Bay Tidal Lagoon, at a fraction of the cost
- further green gas sources such as Biomethane and hydrogen blending are being explored as well as hydrogen cities – all of which need the gas distribution infrastructure
- 20 gas fired peaking plants and hundreds of micro generators with heat recovery are connected to our network - generating flexible, low cost and instant energy when the weather and lunar dependent renewables cannot meet demand
- the gas network currently provides the inter day and inter seasonal storage that simply cannot be delivered by any other means

The UK needs an energy system that remains affordable for all and one that underpins a UK economic growth strategy; the gas network is central to this and hence the risk of asset stranding is extremely low.

There is now a broad consensus<sup>6</sup> that until at least the middle of this century the gas network will be required to cope with broadly the same peak energy requirements as it does today. It will also be required to support the uptake of weather dependent intermittent electricity generation and decarbonisation of transport.

In summary, there may be a changing and more integrated energy system but the importance of the gas network remains constant – at least out to 2050. With this in mind WWU has carried out some ground breaking and independently verified work, including;

- **Bridgend Study<sup>7</sup>** – The only complete objective review of all existing heat technologies in actual homes

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<sup>6</sup> Reports from Imperial College, National Grid FES, EUA Too Hot to Handle

<sup>7</sup> <http://www.smarternetworks.org/Project.aspx?ProjectID=1769#downloads>

- **Cornwall Energy Island**<sup>8</sup> – The only energy simulator to look at daily/hourly energy balancing for an actual region using actual data
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We will continue to develop objective and robust information to allow decision makers to make the right decisions for consumers.

## 20. How do we need to adapt the RIIO framework, and the uncertainty mechanisms in particular, to deal with this uncertainty?

We must retain the principle that the less control a network has over a service or cost then the stronger the uncertainty mechanism should be placed i.e. no control over a required service or cost should result in pass through.

In terms of options for adaptation:

- There is the option to change the current eight year period for all or some of the sectors. This decision would need to consider a wide range of impacts
- Depreciation periods could be changed and/or reviewed. These would have a material impact on the proportion of costs borne by current and future consumers
- “Growth investments” could be linked to certain trigger events but there is a clear danger of the system investment holding up progress
- Investments may be allowed ahead of specific demands, if there is stakeholder support – e.g. investment to support further biomethane connections in the South West if this is supported by key stakeholders there
- Innovation – we have recently seen a “reduced scope” for NIC and NIA innovations to limit innovation benefits to “network” benefits introduced by Ofgem. One option could be a broadening of innovation to include domestic and industrial energy benefits that will ultimately result in reduced costs for consumers. There is a fantastic wealth of knowledge within the networks and we must look to maximise the value of this knowledge

<sup>8</sup> <http://www.smarternetworks.org/Project.aspx?ProjectID=1873>

<sup>9</sup> <http://www.smarternetworks.org/Project.aspx?ProjectID=1978>

<sup>10</sup> <http://www.smarternetworks.org/Project.aspx?ProjectID=1997#downloads>

## 21. Is an eight-year price control period with built-in uncertainty mechanisms still appropriate given the greater range of plausible future scenarios?

There was a significant amount of review that went into the decision on the length of the RIIO-1 price controls. We would recommend a review of that decision, the benefits and challenges that have emerged, and whether or not a move to a shorter period may actually result in consumer detriment.

We fully understand there are some perceived concerns about the current eight year price control period. However there have been clear benefits, some of these include;

- Focus on delivering Outputs for consumers and stakeholders. Shorter periods result in more focus on regulatory settlements and remove focus on stakeholders. It generally takes two years to negotiate a settlement and up to one year to implement a settlement
- Supply chain benefits and stability - the longer period provides stability and favourable contract pricing
- Longer term Totex options for investment decisions. Eight year Output targets are allowing us to innovate and deliver solutions that deliver better value which is a key driver for the efficiencies we are delivering over RIIO-GD1
- The ability to raise finance and financing inputs. Settlements that are transparent and visible for longer periods help provide investor certainty but regardless of the time frame, the settlements need to be attractive to investors and lenders. Shorter periods may give rise to more uncertainty and hence may require increases to risk premia that consumers will ultimately fund.

**Principle 4 - Using the regulatory framework, or competition where appropriate, to drive innovation and efficiency; and (Q22-30)**

## 22. What improvements should be made to the assessment of business plans?

We agree with the principle of simplifying the information provided by networks and this could include less raw data and more analysis prepared by the networks to give Ofgem more time to spend on comparative analysis.

We would encourage some level of consistency and Business Plan guidance to make assessments and comparisons easier for the regulator. We welcome the opportunity to work with Ofgem to ensure early guidance is available.

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The cost assessment toolkit used in RIIO-GD1 was limited and did not take account of aggregated 'Totex', but rather looked at individual elements of spend. These therefore did not necessarily identify the least whole life cost solutions.

Alternative cost assessment tools would be welcome that also link costs to Outputs. The existing gas distribution cost and outputs working group could help to develop and test these options.

### **23. Should we give further consideration to companies' historic performance against their business plans?**

Where historic cost information is relevant it should be used but this must be balanced and not relied on where significant change is expected.

The Business Plan and subsequent allowances must be a function of:

- the latest and current market indicators where applicable,
- the Outputs that stakeholders value,
- efficient assessment of costs – utilising “upper quartile” to avoid cherry picking
- reliable forecasts where available
- fair assessment of WACC

This consultation highlights the scale and pace of change within the energy system. We are also entering a very uncertain and potentially very different economic climate as we exit the European Union. In addition to this, large infrastructure projects such as Hinkley Point C, Swansea Bay and HS2 are competing for resources as is the roll out of smart metering across the UK.

As highlighted in our response to Q22, we would be supportive of developing the toolkit approach to cost assessment through the remainder of RIIO-GD1, ready for RIIO-2.

### **24. Should we determine the revenues an “efficient” network company requires before seeking information from the companies themselves?**

We will own our Business Plan and ensure our stakeholders, have a real voice in deciding our future work. We also know our businesses well, understand its cost drivers, have regional challenges and have a proven track record in efficient delivery. It is not clear at this stage how Ofgem would be able to determine our future revenues upfront without this in depth knowledge.

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It is also unclear how Ofgem will identify the “new Outputs” and stakeholder requirements on which efficient costs would be based.

**25. What has an eight-year price control period allowed network companies to accomplish or plan for that would not have occurred under a shorter price control period?**

Please refer to our response to Q21. In summary, we believe an 8 year price control has supported investor confidence, enabled us to plan more effectively and delivered lower cost contracts which have resulted in savings given back to consumers.

**26. How well has the IQI and efficiency incentive worked in revealing efficient costs through the business plan process and encouraging efficiency throughout the price control period?**

The IQI drives companies to produce quality plans and has driven the right behaviours and lowest cost solutions for consumers. The Totex sharing mechanism is excellent value and protection for consumers. WWU is forecasting to have shared around £46m with consumers by the end of RIIO GD1, provided, of course, these savings are passed on by Shippers.

The current strength of the incentive is also a clear one for networks to reduce costs. Changes to the sharing proportions could dis-incentivise companies to look for lower cost alternatives.

The fast track mechanism is another incentive for companies to publish robust, stakeholder led plans.

**27. What alternative approaches could we consider to encourage companies to give us high quality information that minimises the damage from their information advantage?**

Potential alternative approaches could include some form of independent review of Business Plans. In addition, Ofgem could be more prescriptive about the questions they want answered and the information they require included to ensure companies target their Business Plans accordingly.

## 28. What impact has the innovation stimulus had on driving innovation and changing the innovation culture?

We believe that the innovation stimulus has driven significant innovation culture improvements. Given the pace and scale of change within the energy system and the decarbonisation of heat, our view is that innovation needs to be at the heart of RIIO-2; especially within gas.

It has helped us to drive innovation and in doing so we have established an innovation team, a robust set of processes, strategic focus and governance arrangements creating an innovation programme that has grown in value. A core outcome of this programme is a company-wide culture of innovation with employees engaged in ideation and business led innovation projects.

We have developed relationships with over 250 third party SME's and over 70 unique partners have been successful in gaining circa £4.8m of funding support for innovation projects from us over the first four years of RIIO.

Each year we publish a comprehensive update on the outcomes delivered through our use of the innovation stimulus. This year's publication can be found on our website using the following link - <http://www.wuutilities.co.uk/about-us/our-responsibilities/innovation/>

Together we are collaboratively tackling a number of significant current and future energy challenges.

Collaboration is central to delivering our innovation strategy. We are proud that two thirds of our NIA project portfolio has been delivered in collaboration with one or more of the network licensees.

Clearly, an important benefit of the NIA programme is the ability to share project benefits with others. A particular focus this year has been to assess implemented projects from other networks to identify any benefits for our customers and colleagues. The results of this review highlighted that there are projects that we want to adopt and projects that we want to learn more about, but there are also projects that appear to have limited benefits for our network due to differences that exist, for example in our asset base or in the geography or demographics of our network area.

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## **29. Have the incentives inherent in the RIIO model encouraged network companies to be more innovative and what should we consider further?**

The incentivisation package is encouraging innovative solutions that benefit consumers and reward networks. The symmetrical nature of incentives is also an important principle and balance for network operators and consumers and is a good basis for RIIO-2.

New incentives which help support the UK carbon emission targets, such as developing green gas and the storage provided by gas networks, are clearly beneficial to consumers. An independent report by Imperial College to the Climate Change Committee says that an integrated network will save consumer £8bn per annum<sup>11</sup>. Innovation will be needed to realise those benefits in the form of avoiding the future cost increases of higher cost alternatives.

Revenue incentives, such as the Broad Measure for Customer Satisfaction have driven significant performance improvements and there may be scope to look at similar incentives elsewhere. In addition, it may be timely to review the Guaranteed Standards of Performance. We are ready to work collaboratively with stakeholders, including Ofgem in this area.

## **30. Do you agree that the scope of competition should be expanded in RIIO-2? What further role can competition play?**

We agree that competition should be used within the RIIO framework where it can drive better value for consumers and deliver the lowest whole life cost.

Connections are largely a competitive area for gas distribution, and a large proportion of our works are competitively tendered. However, the competitive advantage of the IGT's pricing models for large private developments should be reviewed. There are also clear consumer benefits of one party efficiently owning and operating a system where competition would just add duplication and cost for consumers.

There may be benefits for very large and separable projects at Offshore Transmission Owner level but there may not be the scale of project at gas distribution level to benefit consumers.

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<sup>11</sup> A ROADMAP FOR FLEXIBILITY SERVICES TO 2030 A Report to the Committee on Climate Change, May 2017 (Imperial College London and Pöyry)

**Principle 5 Simplifying the price controls by focusing on items of greatest value to consumers (Q31-37)**

**31. Which elements add the most complexity and how do you think that these and the broader RIIO framework could be simplified?**

There are some areas that we could look to simplify as we look to future RIIO periods:

- Review the vast amount of data provided to Ofgem as part of the annual reporting process and the RIIO price control setting process. This would make the process more efficient and user friendly for all parties
- Look to utilise more consistent templates for Business Plan submissions
- Improved technology and new communication channels such as blogs and apps can make engagement and communication easier
- Use independent experts for certain complex areas that consumers can then rely on – only engage on things that they can inform
- Independent audits of Guaranteed Standards, Complaints and Customer Satisfaction reporting to ensure compliance and consistency.
- Reduce the number of Outputs and move to outcomes which are understood by the consumers we serve

We have worked hard to reduce complexity for our stakeholders, for example by;

- Ensuring that our website is approved and compliant with Shaw Trust accreditation for accessibility
- Introducing smart apps and social media channels – we have developed a number of customer facing apps and use Twitter, Facebook and messaging services to make engagement more accessible and efficient for customers and members of the public,
- Improving and simplifying our annual stakeholder document to make it more “consumer friendly”
- Using animation and film to show outcomes and processes instead of complex PowerPoint presentations or lengthy Word documents.

We will continue to work with our stakeholders to ensure they understand our business and work with us to make improvements. We are also committed to working with Ofgem to simplify RIIO.

**32. What improvements could be made to the format and presentation of the business plans?**

There are a number of potential options for improvement including;

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- High level and shorter documents with key outcomes – “RIIO on a page”;
- More consistency on structure of narrative from all networks;
- Simplify complex areas
- Reduction of cost information to that which adds value and context to stakeholders, including Ofgem
- Greater use of common methodologies and modelling
- Options to “launch” consultation on business plans at specific planned events

We would be keen to be part of a workgroup to develop agreed thinking in this area, and it would be helpful to develop this area during 2018 to enable the submission of improved business plans ahead of 2021.

### **33. Should the plans be revised at any stage during the price control, for example annually?**

We would not support a move that effectively resulted in annual price control negotiation.

There has to be certainty and transparency for investors and funding bodies. A significant proportion of our services are provided by the external supply chain and we must have stability for them.

An annual change to plans is likely to result in significant contractual risk and premia that would impact on consumer bills.

Furthermore, the administrative burden this places on both the regulator and the regulated will undoubtedly result in a higher administrative and licence cost being passed to the consumer.

We already update our plans at least annually and continually engage with our stakeholders. For example, we already provide the following for stakeholders:

- an annual report on progress, outcomes and forecasts to 2021
- quarterly dedicated workshops for all shipper representatives where we take them through current and future consumer bill updates
- a formal Critical Friends Panel and a number of ad hoc sessions where we shape our annual plans and keep our stakeholders updated with progress, as well as seeking their input and feedback

We would welcome further discussions on how we can engage more effectively with stakeholders to build on our current engagement based on sector best practice.

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### **34. Should we retain fast tracking and if so, for which sectors?**

We support the fast track option as it provides valuable incentives for networks to produce efficient, innovative and well justified plans built on robust stakeholder engagement.

It can also facilitate a shorter price control process, which allows networks more time to focus on delivering stakeholder required Outputs.

We would support continuation of the fast-tracking process with clear upfront criteria published to allow networks to respond accordingly.

In addition to the fast track process, we think that “lighter touch” options for completion of areas of the control that are agreed/deemed efficient may help speed up and simplify the regulatory process.

### **35. Do we collect the right information in the right format and are there better ways to monitor the performance of companies?**

Ofgem currently collects a significant amount of data annually. Only a small part of this data appears to be used by Ofgem in areas such as their annual reviews.

Therefore, there is scope to reduce and refocus the information provided and we would welcome a strategic review of performance information. We are keen to work with Ofgem to understand what is important to them and other stakeholders and how data can be prioritised and tailored accordingly.

Ofgem’s annual report is currently issued almost a year after the end of the reporting period to which it relates and is therefore too out of date to be of any real value to many stakeholders.

The use of more infographics on key outcomes will engage a broader range of stakeholders.

### **36. What are your views on how the changing role of the electricity SO should be factored into the RIIO framework, including whether or not the electricity SO should have a separate price control?**

We are not experts on the development of the electricity system operator. However, the regulation or not of the system operator should be assessed against the consumer

interest test. Our view is that there should be regulation and a separate control if the suite of services are deemed monopoly services and if the scale of Outputs and costs are significant enough to merit a separate control.

### **37. Do you agree with our broad stakeholder engagement approach set out above?**

We do agree with the broad stakeholder approach and timetable. We will also undertake our own engagement throughout the RIIO process.

Whilst we recognise the importance of the consumer as a stakeholder, we must also ensure that all relevant key stakeholders have the opportunity to engage and participate. The operators of the 20 peaking plants, 16 biomethane gas generators and large industrial sites such as TATA Steel and Uskmouth Power Station are effectively new or emerging stakeholders with significant interests in the services we provide and we must ensure their voices are heard during and beyond this process.

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