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2nd May 2018

RIIO-2 Consultation - WWU response

Dear James,

We welcome the opportunity to provide our views on the RIIO-2 Framework consultation and we will be supporting the follow-up working groups and further discussions prior to Ofgem's publication of its decision in the summer 2018.

The regulatory framework must continue to incentivise regulated networks to efficiently deliver the investments and services that underpin the key national & regional policy requirements. These include the Industrial Strategy, the Clean Growth Strategy, and the Wales, Scotland & England climate change targets.

The framework must also promote affordable, secure, and sustainable network services for homes and business. Where appropriate, the regulated networks can then provide independent services to support vulnerable customers and communities.

The existing RIIO framework and our performance within that framework have delivered significant early benefits for customers during RIIO-1 and have locked in future benefits that will be gained into the future.

In headline terms within our first RIIO-GD1 price control, we have delivered:

- Lower customer bills – charges for WWU consumers have fallen to £128 in 2016/17 from £145 in 2013/14, a 12% reduction; a clear indicator that RIIO is working well

- Significant customer service improvements from 8.69 out of 10 in 2013/14 to 9.11 out of 10 in 2016/17 as well achieving the ICS ServiceMark with distinction status.

- Investment that has lowered carbon emissions and improved reliability.

- Ground breaking innovations such as Hybrid heating that will help decarbonise heat whilst minimising the cost and in home impact on consumers.

- 7,500 Fuel Poor connections in 4 years and vulnerable customer support that are supporting the most in need across our geography.

- WWU is on course to meet its Stakeholder defined Output measures whilst returning over £40m back to stakeholders.

- The gas network provides over 80% of energy for heat, circa 40% of energy for electricity and the storage and flexibility that is already supporting a significant increase in renewable electricity

- We continue to meet our safety commitments, keeping our customers safe warm. We have recently been awarded our 5th ROSPA gold award which recognises continued our health and safety performance

Please see the Ofgem Annual Report[1] 2016-17 for all the gas distribution network outcomes to date.

Given its infancy, we agree that the RIIO framework can be improved. We welcomed the independent review of RIIO by CEPA and despite its limitations in scope; we support a number of its conclusions and also disagree with some.

Utilising the existing RIIO Framework, some of the suggestions in the consultation document and our proposals should position Ofgem to make good regulatory decisions to achieve appropriate outcomes for stakeholders. This can be achieved by:

- Resetting cost allowances and workload allowances to reflect RIIO-1 performance whilst recognising RIIO-2 cost pressures - this would reduce cost allowances.

- Changing the price control period to five years from eight years - reducing the risk of long term unintended consequences.

- Introducing appropriate workload volume drivers for the Iron Mains replacement programme – addressing the lack of linkage between Primary Outputs and workload requirements.

- Introducing the indexation of Real Price effects – reducing the scope for up front forecasting errors, and removing windfall gains/losses to network companies.

- Reviewing the Totex sharing factors - addressing the risk/reward balance between networks and customers.

- Strengthening the customer voice with a local Customer Engagement Group and a national RIIO-2 Challenge Group–improving the quality and legitimacy of the business plan process.

- Improving the annual review of performance between Ofgem and networks during the RIIO period – enabling Ofgem to highlight true performance and differentiate between poor and well performing networks.

- Updating Ofgem RORE measure of returns - correcting the current overstatement of returns to our shareholders as published by Ofgem

[1] https://www.ofgem.gov.uk/system/files/docs/2017/12/riio-gd1_annual_report_2016-17.pdf

- Enabling shareholders of an efficiently run company to earn a fair return for the risks that they face. Fair return being measured using a complete RoRE calculation to better reflect the return equity investors are achieving from the regulated business – improving the transparency and legitimacy of the measurement and reporting of shareholder returns.

- Updating the debt allowance to reflect actual costs incurred, subject to an efficiency test – this will avoid windfall gains and losses.

We are therefore supportive of an evolutionary RIIO framework update. The RIIO framework involved significant consultation in its conception, and the improvements it has delivered over prior controls should not be discarded. The significant updates to the framework outlined above would still offer an incentive based framework addressing some “first time” implementation issues with RIIO without destroying the intent of the RIIO framework.

The package of measures outlined above and within our responses below, removes the need for untested and ex-post measures that would add further complexity and turn RIIO into a rate based form of regulation.

In summary, the regulatory framework must continue to incentivise regulated networks to efficiently deliver the investments and services that underpin the key national & regional policy requirements.

We support Ofgem’s focus on a whole systems approach to ensure stakeholders gain maximum benefit from our gas and electricity networks and expertise.

The framework must also promote affordable, secure, and sustainable network services for homes and business. Where appropriate, the regulated networks can then provide independent services to support vulnerable customers and communities. We look forward to working with the Ofgem RIIO-2 team and other interested parties as the framework develops and as the sector specific methodologies are consulted upon.

Yours sincerely

Steve Edwards
Director of Regulation & Commercial

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Wales & West Utilities

RIIO-2 Consultation Summary Response

We believe that the RIIO framework has worked well for consumers during RIIO-1 and has delivered a number of significant benefits and as such, many of the aspects should remain whilst others could be improved:

- **Outputs** which are well defined and represent what consumer's value.
  - We look forward to reviewing the Outputs required for RIIO-GD2 in detail at the sector specific consultation stage.
  - We agree non-delivery of outputs and outcomes should mean that customers are refunded the corresponding allowance.
  - We are committed to delivering our RIIO-GD1 outputs.
  - We recommend more weighting is given to the independent measures and benchmarks we have to achieve, for example BSI 18477 accreditation for inclusive service provision, ICS Service Mark accreditation.
  - We support the need to maintain 'absolute' rather than relative targets which have delivered excellent outcomes for customers in RIIO-1 whilst also encouraging collaboration and sharing of best practice.
- **Incentives** need to continue to be strong enough to deliver long term value for consumers.
  - Including information revealing devices such as the IQI.
  - We would encourage new whole system incentives and green gas incentives.
  - We must avoid a situation where incentive targets are not known until final proposals, we recommend early establishment of RIIO GD2 Output and incentive workgroups.
- **Innovation** funding for long term value projects.
  - The change in the energy sector needs to be supported as we adapt and innovate to respond to the trilemma.
- **Revenue** package which includes an appropriate risk reward balance.
  - The framework needs to provide opportunity and incentives to enable the best performing companies to outperform.
  - We do not support the failsafe mechanisms proposed such as anchoring returns.
  - We are concerned about dis-incentivising the investor community and discouraging innovation and outperformance; resulting in not delivering best value for our customers.

We support the need to review the framework and in summary our views are as follows: -

- **Cost of debt**

  - Needs to prevent windfall gains and losses.

  - We support option 3 on pass through (subject to an efficiency test) and attach an independent report by OXERA which concludes that our debt was raised efficiently and that we will not be adequately compensated for those efficient debt costs if a rolling index based approach continues[2].

- **Cost of Equity**

  - A separate analysis has been undertaken by OXERA for the ENA which will be submitted in response to Ofgem's Framework Consultation.

  - We have raised some specific matters for Ofgem to consider.

- **RORE**

  - The current measure is incomplete and misleading as it doesn't include performance against debt, pension deficit or tax allowances. It must be updated to include these elements.

  - Adjusting the measure in this way would enable a more accurate reporting of performance of network companies.

- **Indexation of TOTEX**

  - We support the indexation of RPEs.

- **RPI to CPI / CPI(H)**

  - No rationale has been provided by Ofgem for its proposal to move away from RPI. Consistent with maintaining a stable and low risk regulatory environment, a separate consultation should be undertaken by Ofgem with all stakeholders, including investors, and policy formulation should be based on the principles outlined in our answer to question 41.

- **Floors and Caps**

  - We do not agree with the introduction of any mechanisms which cap or limit the returns as they will also restrict the benefit to the consumer.

- **In period Cost Allowances Changes**

  - Undermine the price control contract and drive huge uncertainty.

[2] RIIO GD2 Preparation: Cost of Debt 26 April 2018

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- Subjective and informal "voluntary arrangements" for returns of revenue are inappropriate, are poor regulation, and damage the legitimacy of the regulator and the network.

- We support clarity in the licence and formally documented processes that define in advance of the control period starting how over delivery / under delivery is addressed.

- Ofgem must allow funding of licence obligations – this is a fundamental requirement and we therefore question if we have misunderstood the sentence in paragraph 6.14 "There will be no direct funding for these Licence obligations."

➢ **Enhanced Engagement**

- Increases legitimacy and we support the role of the new Customer Engagement Groups for GDNs and are we well underway with this; noting this needs to remain proportionate.

- We recognise the role that Ofgem's RIIO-2 challenge group can play and welcome further detail on how this will operate and timelines to ensure we respond comprehensively.

CHAPTER 3 - GIVING CONSUMERS A STRONGER VOICE

Q1 How can we enhance these models and strengthen the role of stakeholders in providing input and challenge to company plans?

→ **What are your views on the proposal to have open hearings on areas of contention that have been identified by the groups?**

We support the need for enhanced engagement and an improved consumer voice. We agree that this will lead to a better quality business plan and recognise there is value in building upon the engagement which has been undertaken throughout RIIO GD1.We pride ourselves on putting customers first, building trust by giving excellent service, listening and taking action on what our customers tell us.

Authentic stakeholder engagement and participation is a positive step forward for the gas industry as a whole and we welcome the opportunity to further build on progress made during RIIO GD1.

We believe the role of a CEG (Consumer Engagement Group) will be central to supporting this aim. We welcome the guidance document issued on 9 April and we are eager to set up our CEG in the near future as we will have a short period of time in which to educate the members on our business before working closely with them in developing our business plans. We are keen to understand further how Ofgem plan to evaluate our engagement and the detailed scope for the assurance reports as soon as possible.

We recommend that the scope of the CEG remains proportionate and whilst we acknowledge the group will need to understand our business plans in order to know if we have incorporated stakeholder feedback; we want to avoid duplication between the CEG and our existing stakeholder groups (including our critical friends panel) who will be reviewing the detail of our business plans. We expect the CEG to review the feedback we have been given by these stakeholders with a view to understanding how we have built their feedback into our business plans. We advocate proportionality and we will look to Ofgem to ensure that the scope, expenditure, and resources are reasonable and consistent to ensure customers across the UK are treated equally.

We support the principle of the RIIO-2 challenge panel and we would welcome an early indication of the timelines ahead of the summer 2018, to ensure that our business planning process allows for proportionate and quality engagement. We are also keen to understand their remit further as well as the membership. It is our view that the members need to represent a wide range of stakeholders including, but not limited to, consumer groups, large users, businesses, investors, suppliers, and future consumers.

We understand the intention of the Open Hearings proposal however we would like to understand the timing and scope further. We understand that these are exclusively for price control reset purposes only; not for general use throughout the control period and would expect the use of appropriate experts.

CHAPTER 4 - RESPONDING TO HOW NETWORKS ARE USED LENGTH OF PRICE CONTROL

Q2 Do you agree with our preferred position to set the price control for a five-year period, but with the flexibility to set some allowances over a longer period, if companies can present a compelling justification, such as on innovation or efficiency grounds?

- **→ What type of cost categories should be set over a longer period?**
- **→ How could we mitigate the potential disruption this might cause to the rest of the framework?**
- **→ What additional measures might be required to support longer-term thinking among network companies?**
- **→ Do you instead support the option of retaining eight-year price controls with a more extensive Mid-Period Review (MPR)?**
- **→ What impact might the alternative option of an eight-year price control with a more extensive MPR have on how network companies plan and operate their businesses?**

We support the proposal of a five-year period to provide improved predictability and would prefer this to an 8 year control with a more extensive midpoint period which could create significant uncertainty. However, we would not support a five-year period with interventions during the period; as this raises risk and uncertainty. We believe, however that a shorter period must be balanced and allow for top performing networks to earn additional rewards to drive benefits for customers.

We are happy to consider the option of setting allowances over a longer timeframe. However, any investment area with non-standard period would have to be clearly ring fenced from other investment. This is an area we would welcome a follow-on discussion with Ofgem and the other stakeholders.

We recommend that Ofgem explore options with networks to incentivise plans that demonstrate strategies beyond the price control and reward companies who demonstrate they have tested plans against varying future scenarios.

At this stage we do not have any areas in mind for a shorter control however if there are any areas this may be suited to, we wouldn't want to rule out this option.

We provide further responses on the risk/reward balance and linkages of different parameters within chapter 8.

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WHOLE SYSTEM OUTCOMES

Q3 In what ways can the price control framework be an effective enabler or barrier to the delivery of whole system outcomes?

- → **If there are barriers, how do you think these can be removed?**
- → **What elements of the price control should we prioritise to enable whole system outcomes?**

The regulatory framework must continue to incentivise regulated networks to efficiently deliver the investments and services that underpin the key national & regional infrastructure and policy requirements. These include the industrial strategy, the clean growth strategy and the Wales, Scotland and England climate change targets in addition to local policies and targets.

The price control process must facilitate whole systems outcomes. If we get the right investment within the right sectors, consumers will benefit.

We fully support the need for Ofgem to take a 'whole systems' approach; Power, Gas Transmission and Distribution. The gas network provides over 80% of energy for heat, circa 40% of energy for electricity and the storage and flexibility supporting a significant increase in renewable electricity.

Q4 Do you agree with our minded-to position to retain the current start dates for the electricity transmission and electricity distribution price controls, and not align them?

We do not agree with the minded-to position to retain the current start dates for electricity transmission and electricity distribution.

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. Therefore, aligning the electricity price controls appears to be a sensible step that would support the broader energy challenges.

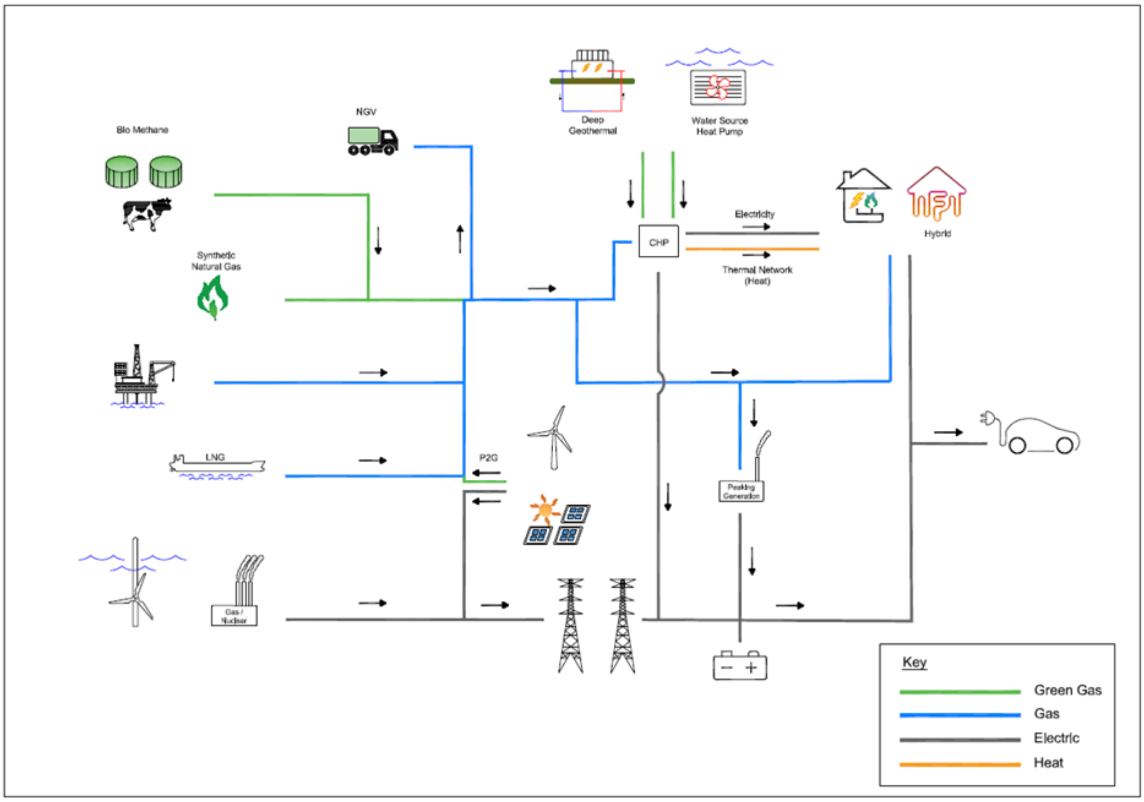
One barrier to further developing the whole systems thinking is in respect of networks not preparing business plans in tandem; the different timing of the price control periods does not help this issue. However we recognise the resource challenge for Ofgem in aligning controls and we would be keen to develop a process which requires networks to evidence stakeholder views from the other sectors to ensure a joined up approach. We also recognise the role that the RIIO-2 challenge group has to play in reviewing cross network and cross vector business plans and we look forward to understanding this further in the near future.

Q5 In defining the term 'whole system', what should we focus on for the RIIO-2 period, and what other areas should we consider in the longer-term?

- → **Are there any implementation limits to this definition?**

We have seen a change in the use of our network during RIIO GD1. We are now supporting the decarbonisation of electricity by connecting generators directly onto the distribution network when renewable energy isn't sufficient to meet demand- to date we have 31 connected directly to our network with an output approaching 2.0GW. As the power system becomes increasingly variable with closures of coal and nuclear generating capacity, we forecast this will figure will increase in the future.

We see the gas and electricity networks working ever more closely as we go into the future to deliver low carbon, low cost heating. Here is a pictorial view of how integrated the networks currently are and hence supports the need for Ofgem to focus on ‘whole system’ outcomes:



More information is available from the 'On the Road to Green Energy' paper on our website [3]

We would propose that the definition of whole systems goes beyond energy and heat to include transport and waste; recognising the clear linkages between these. We are already seeing a CNG fleet including gas buses connecting to our network in response to the Clean Air Act and we forecast this will increase. Electric Vehicles are also on the increase and where there are system capacity constraints on the electricity network, the gas network is able to support this. In terms of waste, we are proactively encouraging green gas into our network with 18 sites connected with capacity to supply 127,000 homes as well as the ground breaking BioSNG project at Swindon which uses waste.

All of these changes are being experienced today and we believe they will continue as the UK decarbonises further.

We have been working in partnership with a number of organisations to develop a model which helps us to forecast the impact of different future energy scenarios – ‘The 2050 Energy Pathfinder’ model[4].

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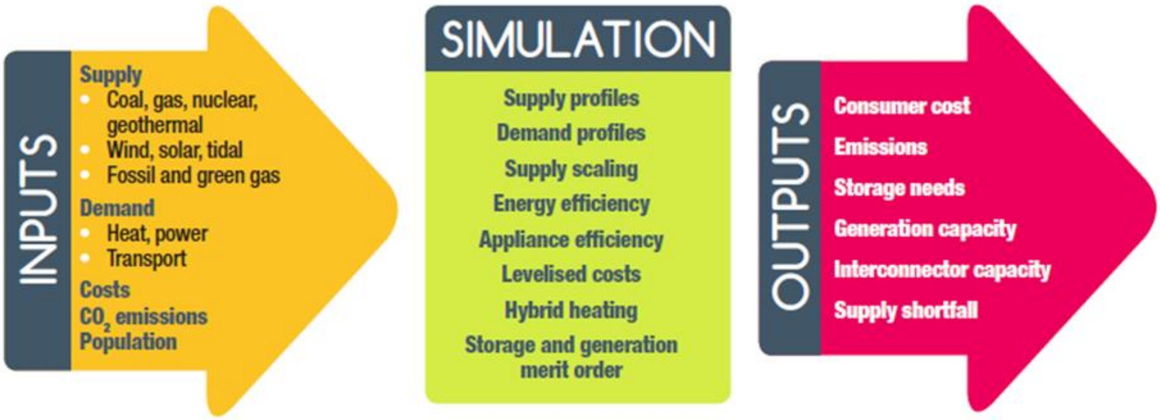
[3] http://www.wwutilities.co.uk/media/2611/on-the-road-to-a-green-energy-uk.pdf

[4] http://www.wwutilities.co.uk/media/2661/2050-energy-pathfinder-short-paper.pdf

This simulator has been built to assess the feasibility of how different future energy mixes would work in practice. Its inputs and outputs are summarised here:



The 2050 Energy Pathfinder enables any energy scenario, current or future, to be modelled for a town, city, county or country and the results show the costs, carbon impact, and any shortfall/surplus in heat and power supply. The simulator can determine the feasibility of alternate solutions across all energy types in a more integrated way. We would be keen to share the simulator with Ofgem to further support the development of the whole systems thinking.

We would encourage Ofgem to develop 'whole system' incentives and outputs and we are keen to work alongside Ofgem and the gas transmission and electricity distribution and transmission accordingly. Cross sector working groups chaired by Ofgem have worked well with NOMs and we would recommend this approach to develop thinking further here. We are currently working closely with transmission and have set up a joint working group via the ENA to look at how we join up our investment further.

We would also encourage Ofgem to incentivise plans that demonstrate consideration of 'trade-offs' of investment across sectors to achieve customer outcomes by delivering the best value options.

SYSTEM OPERATOR PRICE CONTROL

Q6 Do you agree with our view that National Grid's electricity SO price control should be separated from it's TO price control?

The decision to separate the electricity SO and TO price controls should be based on what is best for the customer.

Q7 Do you agree that we should be considering alternative remuneration models for the electricity SO?

→ **If so, do you have any proposals for the types of models we should be considering?**

WWU is not in a position to provide a response to this question.

Q8 Should we consider alternative remuneration models for the gas SO?

→ **If so, why and what models?**

It is our view that there should be regulation and a separate control if the suites of services are deemed monopoly services and if the scale of outputs and costs are significant enough to merit a separate control.

NETWORK UTILISATION, STRANDING AND INVESTMENT RISK

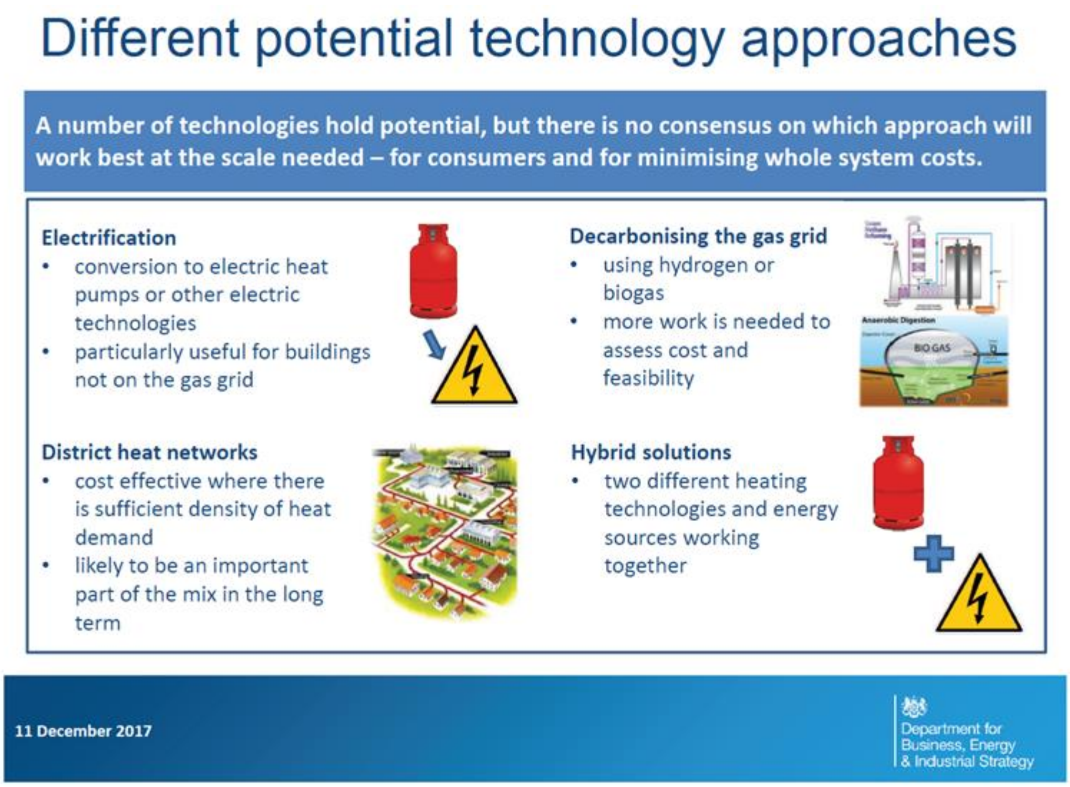
Q9 What options, within the price control, should be considered further to help protect consumers against having to pay for costly assets that may not be needed in the future due to changing demand or technology, while ensuring companies meet the reasonable demands for network capacity in a changing energy system?

We would encourage Ofgem to use the evidence available across the UK to support the assessment of future investment into the gas networks as well as the cost of not investing. For example, Imperial College identified considerable benefits accruing to the energy system as a whole by spending about £178m annually on gas to substitute electricity in hybrid heating systems during certain times of the year. The system is able to achieve gross savings in total cost of more than £1.3bn per year.

Technology Options

	Capital Cost	Running Costs	Disruption	Carbon
Gas Boiler	L	L	L	H
Heat Pumps	H	L	H	L
Heat Networks	H	L	H	L
Hydrogen	L	H	L	L
Hybrids	L	L	L	L

We support the need to ensure charges to both todays and tomorrow's customers avoid any unnecessary investment. Our detailed analysis using the Pathfinder model (as explained in response to questions 3, 4, & 5) demonstrates that the gas network has a role to play in all future heat decarbonisation scenarios due to this being a lower cost than the alternatives. Whilst there is no explicit heat policy at this time and the optimal path for heat decarbonisation may be unknown; BEIS acknowledge the role gas has to play in the low carbon future:



In addition the role of gas into the future is intrinsic in The 'Future of Energy Scenarios[5]' published by National Grid in 2017. The '2 degrees' scenario suggests that peak demand for gas in 2030 will still be at 83% and in the 'slow progression' scenario, which is closest to the current environment. There is significant independent evidence to demonstrate the role of gas including an independent report by Imperial College to the Climate Change Committee says that an integrated network will save consumer £8bn per annum[6]

We recognise our business plans will need to clearly demonstrate the need for investment via robust evidence in addition to confirmation we have taken account of stakeholder feedback. We welcome Ofgem's enhanced engagement proposals which will ensure legitimacy of investment with any areas of contention being addressed via

[5] http://fes.nationalgrid.com/fes-document/fes-2017/
[6] https://www.theccc.org.uk/wp-content/uploads/2017/06/Roadmap-for-flexibility-services-to-2030-Poyry-and-Imperial-College-London.pdf

the Open Hearings Process. We welcome the increased scrutiny in the development of our business plans.

END-USE ENERGY EFFICIENCY

Q10 In light of future challenges such as the decarbonisation of heat, what should be the role of network companies, including SOs, in encouraging a reduction in energy use by consumers in order to reduce future investment in energy networks?

→ **What could the potential scale of this impact be?**

We welcome the opportunity to explore the role of gas networks in delivering energy efficiency advice and support with appropriate funding in place. We are already working with a number of partners to offer energy efficiency advice amongst other services which provides a great value interaction; we are planning to extend this further throughout GD2. The scale of impact could be material but we would welcome further discussion with Ofgem and relevant stakeholders.

For those in fuel poverty we have connected 7,500 homes to the gas network between 2013/14 and 2016/17 as it is a more efficient way of heating their homes whilst also resulting in lower bills. We support the continuation of this going forward. We undertake this work with partners who are able to support further with, amongst other things, energy efficiency advice, and insulation.

We are working in partnership with Western Power Distribution to support energy efficiency in the homes delivered via The Freedom Project[7], a hybrid heating system which smartly switches between a gas boiler and an air source heat pump. The switching takes account of the efficiency of the fuel source itself as well as the efficiency of the use of that fuel source via the heat pump and the boiler to deliver the most efficient source of heat to the home. BEIS are engaged with this project and we will continue to keep them updated on progress to inform their future heat policy.

[7] http://www.wwutilities.co.uk/media/2662/freedom-project-interim-report-february-2018.pdf

CHAPTER 5 - DRIVING INNOVATION AND EFFICIENCY

Q11 Do you agree with our proposal to retain dedicated innovation funding, limited to innovation projects which might not otherwise be delivered under the core RIIO-2 framework?

We believe that the innovation stimulus has driven significant innovation culture improvements and 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.

We have developed relationships with over 335 third party SME's and over 98 unique partners have been successful in gaining circa £6.7m of funding support for innovation projects from us over the first four years of RIIO. We are proud that two thirds of our NIA project portfolio has been delivered in collaboration with one or more of the network licensees.

The current NIA arrangements hugely support collaboration and sharing of benefits with others. We support the need for continuing the innovation stimulus where projects demonstrate long term value and provide UK-wide benefits; where the projects are speculative and high risk.

The potential removal of the innovation stimulus for what Ofgem describe as 'BAU' has the risk of reducing the appetite to collaborate and share benefits and result in silo mentality which would not be in the interests of the UK consumers. In any event, it is important innovation is funded to ensure best value is delivered to both today's and tomorrow's consumers.

Q12 Do you agree with our three broad areas of reform: i) increased alignment of funds to support critical issues associated with the energy transition challenges ii) greater coordination with wider public sector innovation funding and support and iii) increased third party engagement (including potentially exploring direct access to RIIO innovation funding)?

We agree with increased alignment of funds for energy transition challenges. We would be wary of the reference to the Australian Regulator's approach to a targeted innovation mechanism which are too narrow – please refer to the report[8] which sets out the concerns.

However, we are not supportive of greater co-ordination with wider public section innovation funding as it will limit our innovation activities considerably in the current landscape. These funding streams have no forward programme, are generally thematic (so no guarantee of energy or decarbonisation being a theme), have differing and often complex application processes, they dictate the start dates which limit agility and often need a specified consortium for delivery. This is in addition to the issue that many of the funds do not provide a sufficient proportion of project costs to make the projects viable. We are concerned that this could slow up innovation considerably, especially

[8] http://www.energynetworks.com.au/sites/default/files/network_innovations_26072017.pdf

given that WWU has been benchmarked by the EIC as having the shortest window from idea to project idea evaluation of under a month.

We agree with growing the amount of 3rd party engagement and we strive to actively promote collaboration and are committed to encouraging this further. We are not convinced of the benefits of allowing 3rd parties to access funds directly. In autumn 2017, we ran a collaborative NIC call for ideas from 3rd parties however we didn't receive any response. We are open to discussion however the networks involvement in any such projects is very high (e.g. design, field trials and benefits tracking etc.) and therefore we are struggling to see the benefits of this.

Q13 What are the key issues we will need to consider in exploring these options for reform at the sector-specific methodology stage, including:

(i) What the critical issues may be in each sector and how we can mitigate the bias towards certain types of innovation through focusing on these issues?

The critical issues are detailed in the Gas Network Innovation Strategy[9] that has been collaboratively developed for the gas sector. We ensure that bias is avoided by keeping the programme open and flexible & aligned to the strategy.

(ii) How we can better coordinate any dedicated RIIO innovation funding with wider public sector funding and support (including Ofgem initiatives such as the Innovation Link and the Regulatory Sandbox)?

Please refer to our response to Q12 above; co-ordination with wider public funding would be extremely difficult.

(iii) How we can enable increased third-party engagement and what could be the potential additional benefits and challenges of providing direct access to third parties in light of the future sources of transformative and disruptive innovation?

Please refer to our response to Q12 above; we are not convinced of the benefits and in addition we had been advised previously by Ofgem that a primary legislation change is needed for this; we would welcome further clarification on this.

Q14 What form could the innovation funding take.

→ What would be the advantages and disadvantages of various approaches?

Ofgem has recently introduced a "reduced scope" for NIC and NIA to limit innovation benefits to "network" benefits. 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.

Where the risk is low (i.e. a high Technology Risk Level 'TRL') we recognise that the level of funding could be reduced; recognising the increased certainty of the innovation

[9] http://www.wwutilities.co.uk/media/2691/gas-network-innovation-strategy-2018.pdf

delivering benefits. However, where the risks are higher (i.e. a low TRL) we are supportive of a correspondingly high proportion of funding.

If the innovation stimulus is removed for ‘BAU’ and replaced with cost allowances, we would support further discussion to design a new output to measure the collaboration to reduce the impact of silo mentality mentioned above. It is also worth noting that when projects today are successful and are implemented into BAU we continue to invest in the project by way of developing policies, purchasing products, training our people as well as tracking the benefits; this is unfunded under the current mechanisms.

Q15 How can we further encourage the transition of innovation to BAU in the RIIO-2 period? How can we develop our approach to the monitoring and reporting of benefits arising from innovation?

Understanding the benefits of innovation is crucial to demonstrating success as well as developing our learning. We continue to work with Ofgem and the other networks to develop robust benefit measurement models and we will continue to support this work to seek a suitable solution.

COMPETITION

Q16 Do you agree with our proposal to extend the role of competition across the sectors (electricity and gas, transmission and distribution)?

- **→ What are the trade-offs that will need to be considered in designing the most efficient competitions?**

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.

In terms of expanding the scope of competition in gas distribution we would welcome further discussion however the level of spend and the size of the capital projects are unlikely to be large enough to qualify for such competition or deliver the value and benefits to consumers. A large part of GDN expenditure is already competitively tendered and reflects market conditions of the day. In addition, we periodically test our delivery efficiency against the market. This is delivering benefits to consumers.

In terms of trade-offs it is important that Ofgem consider the impact of any current benefits and value customers are receiving today and to ensure the introduction of formal competition doesn’t limit the market opportunity where networks are best placed deliver the best value service.

Q17 Do you consider there are any reasons why our new, separable and high value criteria might not be applicable across all four sectors?

- **→ If so, what alternative criteria might be suitable?**

The proposals to expand the scope for late models of competition seem sensible in both Gas and Electricity Transmission and Electricity Distribution where the projects are large enough to deliver the benefits of competition.

As mentioned above, the level of spend in Gas Distribution may not be sufficient to warrant this process. However, we would be keen to work with Ofgem and the other network operators to understand how we can deliver whole system outcomes in a more joined up way. For example by allowing the gas distribution networks to compete, where appropriate, for investment which solve constraints on the electricity network and vice versa.

Q18 What could the potential models be for early stage competitions (for design or technical solutions)?

- → **What are the key challenges in the implementation of such models, and how might we overcome them?**

We support the principle of early stage competition to allow parties, other than incumbents, to propose innovative solutions; this supports our view above where we may be able to provide a more cost efficient solution than the electricity and/or gas transmission offering and vice versa. We would welcome further discussion as to how this could work in practice.

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CHAPTER 6 - SIMPLIFYING THE PRICE CONTROLS

We welcome the approach to consider simplification of the price control. It is our view that RIIO-1 is working well for customers and only needs some minor tweaks.

OUR APPROACH TO SETTING OUTPUTS

Q19 What views do you have on our proposed approach to specifying outputs and setting incentives?

There is clearly the need to work through the detail on specifying outputs and incentives through the sector specific process to ensure stakeholder focussed outcomes. Our comments here focus on the principles outlined within the consultation document. Our key points of principle are:

OUTPUTS

- We fully support linking network Revenues to Output delivery.
- We broadly support the six output category areas but in terms of balance, we suggest a greater emphasis on energy efficiency, support for vulnerable customers and decarbonisation of heat within a whole systems approach. This view is informed by the feedback we are getting from our stakeholders and the key challenges outlined by decision makers such as Welsh Government, BEIS, and UK Governments.
- We must take the time with stakeholders to set robust Outputs well ahead of the start of RIIO-2 and we cannot rush or continue to develop Outputs into RIIO-2. We are still defining the NOMs outputs six years into RIIO-1 and the Interruptions targets needed amending because they were set at the last minute without GDN involvement. We must take this learning into RIIO-2.

INCENTIVES

- Well calibrated incentives benefit consumers.
- We fully support the principle that additional financial incentive income or penalty is linked to above or below baseline funded levels. These arrangements are already in place for RIIO GD1 and are working well for consumers and networks.
- We agree there should be a mix of financial and reputational incentives, and reputational incentives should be used where there is not enough information to support financial incentives.
- We must avoid a situation where incentive targets are not known until final proposals, we recommend early establishment of RIIO GD2 Output and incentive workgroups.

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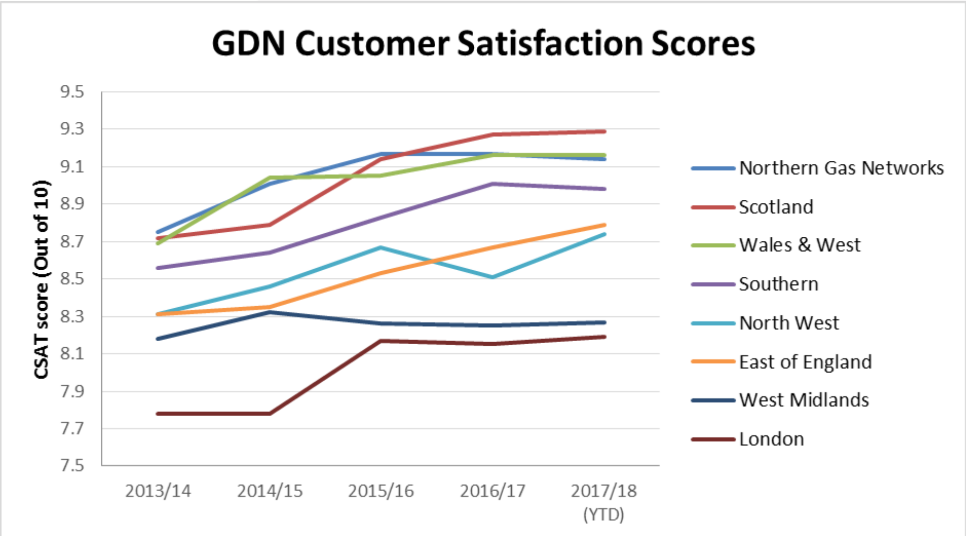
COST ALLOWANCES

- We must ensure there is a robust cost allowance toolkit to get the ex-ante cost allowances right.
- Changes to Output levels and cost allowances during the period are not acceptable. This would drive huge uncertainty for stakeholders, networks, and regulators and undermine a price control contract.
- The regulatory contract must be honoured and we support clarity in the licence and formally documented processes that define how over delivery / under delivery is addressed.
- Subjective and informal "voluntary arrangements" for returns of revenue are inappropriate and result in poor regulation which damages the legitimacy of the regulator and the networks.
- Ofgem must allow funding of licence obligations – this is a fundamental requirement and we therefore question if we have misunderstood the sentence in paragraph 6.14 "There will be no direct funding for these Licence obligations." We must have further detail on Price Control Deliverables and associated revenue allowance; noting its limited scope in the consultation as it stands today.

→ **When might relative or absolute targets for output delivery incentives be appropriate?**

Absolute targets have delivered huge improvements for customers (e.g. Customer Satisfaction for gas distribution) and we recommend this approach is continued. This is supported by the significant performance improvements across the sector over RIIO GD1 an example of which can be seen below in terms of the customer satisfaction scores for the GDNs:



An absolute target allows networks to perform and target improvements against a known point. This is not the same for relative targets which may damage consumer outcomes. In addition, a move to relative targets does not promote collaboration and sharing of best practice and unnecessarily increases uncertainty and risk.

→ **What impact would automatically resetting targets for output delivery incentives during a price control have? Which outputs might best suit this approach?**

Changes to Output levels and cost allowances during the period would increase risk to equity, drive huge uncertainty for stakeholders, networks, and regulators and undermine a price control contract. This would have a significant negative impact on financeability which would ultimately result in higher financing costs being passed on to consumers. The reduction of a price control period down to five years coupled with strong regulation, incentives and sharing factors is a more stable and sustainable approach.

OUR APPROACH TO SETTING COST ALLOWANCES

Q20 What views do you have on our general approach to setting cost allowances?

There are a number of themes covered within chapter six and this is a significant part of the RIIO framework. We outline below our views on the themes raised within this section of the consultation

Cost Assessment Toolkit

- We must start the process to establish the toolkit for cost allowances in RIIO-2 now. This is possibly the key issue that underpins much of the negative press for RIIO-1.
- We have a major opportunity to utilise the mass amount of information we have on network costs generated through RIIO-1.
- We should be testing the robustness of efficiency comparisons through the remainder of RIIO-1.
- We encourage Ofgem to ensure they have the capability to play a full role with networks to learn from the RIIO-1 experience.
- We must start the close out of RIIO GD1 early and ensure this does roll forward into RIIO GD2.
- Ofgem reporting from now on needs to include efficiency comparators so that we test ahead of RIIO-2.
- Ofgem needs to publish information to networks well ahead of BP submission to allow networks to plan effectively and engage with stakeholders.

GD2 Cost Allowances

- The cost allowances for RIIO-2 cannot simply be backward looking and must take into account evidence of forward looking challenges.
- Changes to Output levels and cost allowances during the period would drive huge uncertainty for stakeholders, networks, and regulators and undermine a price control contract. This would have a significant negative impact on

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financeability which would ultimately result in higher financing costs being passed on to consumers.

  - The reduction of a price control period down to 5 years coupled with strong regulation, incentives and sharing factors is a more stable and sustainable approach.

- Ofgem must allow funding of licence obligations – this is a fundamental requirement and we therefore question if we have misunderstood the sentence in paragraph 6.14 “There will be no direct funding for these Licence obligations.”

- Where historic costs are available and can be relied upon, we support these being used as part of the Ofgem cost assessment process. Where future forecasts (of costs **and/or work types**) are available, and these demonstrate that historic evidence isn’t representative of future work requirements, for example on our long term repex programme, these should also be taken into account when setting costs allowances.

- In any event, a level of flexibility needs to be maintained within the cost allowance framework to allow companies to manage the most efficient programme to deliver the outputs that have been promised.

- We support the use of appropriate volume drivers for areas like Repex spend that will avoid windfall gains or losses as a result of workload variations.

- We agree a mix of ex-ante allowances, re-openers and pass through mechanics are all part of the cost allowance package. The key principle is that networks should manage the risks that they can affect and be protected from costs outside of their control by re-openers and pass through.

- There is firm link to the cost of equity and risk profile of network businesses. If there are changes in the cost allowance toolkit, this must be reflected in the cost of equity.

- We support indexing of factors that are difficult to forecast such as RPEs. The key issue is making sure the index appropriately reflects the costs we are trying to manage.

- We must have alignment in cost allowances and regulatory treatment where one sector charges another – E.g. distribution and transmission. This has been an issue in RIIO-1 and has impacted competition during RIIO-1.

Q21 What views do you have on our intention to index RPEs?

We support indexing of factors that are difficult to forecast such as RPEs. The key issue is making sure the index appropriately reflects the costs we are trying to manage.

We also support appropriate workload volume drivers where linkage to primary outputs is difficult. This would support differentiation and remove mechanistically the opportunity for windfall gains/losses.

If we get the base cost allowances, indexation, volume drivers, and sharing mechanisms correct within a shorter 5 year period then this removes the need for any revenue caps and should provide a sustainable regulatory framework.

Q22 What impact would resetting cost allowances based on actual cost performance (e.g. benchmarked to the average, upper quartile or best performer) during a price control have? Which cost categories might best suit this approach?

Such a change would add significant complexity and have a significant impact on the risk profile of a network and need to be reflected to equity and ultimately will add costs to network bills. Period adjustments reflect poor regulation and a weakening of the regulatory contract and increases uncertainty to investors.

We support the principle that bill payers benefit from improvements in network efficiency at the price reset. In addition to the benefits consumers get at the price reset a key change introduced at RIIO-1 was the annual sharing mechanism. We therefore think this process should continue. The RIIO-1 framework is delivering significant service and bill improvements for customers – we must not lose this.

We have highlighted above that we also support indexation of RPEs and use of workload drivers that again provides substantial and new protections for consumers.

Therefore, the package outlined above would be more sustainable and stable than a framework that adjusted costs / outputs annually.

INFORMATION-REVEALING DEVICES

Q23 Do you agree with our assessment of IQI?

The Ofgem assessment of IQI is incomplete. Ofgem had not published the IQI matrix ahead of RIIO GD1 business plan submission deadlines and as a result of this the gas networks were unable to “respond” to any incentive that the IQI matrix or fast tracking may have driven. Therefore, to conclude that the IQI was not an effective information revealing device for networks is incorrect.

The IQI could be an effective information revealing device if published and known in advance of business plan submissions and we would welcome further discussions with Ofgem on the options.

Q24 Do you agree with our assessment of fast-tracking?

The fast track process for RIIO GD1 was the first time it was used and the benefits were not well defined ahead of our business plan submission. No gas distribution network was fast tracked and therefore it is not possible to assess the value for gas distribution. The fast process evolved for ED1 and Ofgem made good progress in defining the scope & benefits for ED1.

The fast track process is a useful tool in the price control toolkit. The key issue is how it is implemented & the scale and scope of reward. The fast track process can also allow a shorter price control settlement process and therefore promote more focus on delivering for stakeholders.

Our view is that fast track process should be retained and the principles / decision criteria should be published in advance of business plan submission.

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We are not supportive of fast track companies having a differential Cost of Capital however we support a differential sharing factor. It is our view that when this is combined with the reputational benefits, the reduced scrutiny and hence effort in finalising the control and well as the ability to focus on implementation sooner than the slow track companies, the IQI is an appropriate incentive to encourage high quality business plans.

Q25 What are your views on the options we have described?

The IQI and fast track incentives are part of an overall package. RIIO-1 was the first time that networks had to submit business plans and forecast costs for the new RIIO-1 outputs for an 8 year period. As CEPA highlight, regulation of networks is a "repeat process" and benefits will be gained by repeating the process and learning from past cycles.

Customers have benefitted from Network cost outperformance and this has been automatically shared through the Totex incentive mechanism. Customer cost reductions have been achieved against a backdrop of significant service improvement, innovation, and significant investment delivered.

Underspends and overspends versus allowances occur for a number of reasons. Therefore, it is difficult to value the IQI and fast track process in isolation.
Underpinning these incentives is the Ofgem and company view of cost allowances to deliver the stakeholder required outputs.

For RIIO-2 gas distribution, Ofgem, networks, and stakeholders have much greater visibility of the most recent costs to deliver the stakeholder required outputs. We also note the proposals for a shorter price control period, use of indexation for certain costs – e.g. RPEs and potential volume drivers.

Our view is that the IQI and fast track should be retained for gas distribution (Option 1) noting the interactions and linkages to the points highlighted above.

To promote greater success of the IQI and fast track incentive, Ofgem must publish greater detail and guidance ahead of the business plan submission process. Without this, we cannot respond to the incentives.

We do not agree that cost allowances should be based on Ofgem's view alone. Using Ofgem's view will significantly undermine the requirement for a company business plan and remove the need to develop local consumer engagement panels and an independent national group.

We note option 3 - The single business plan incentive is highlighted as a combination of the IQI and Fast track but there is little detail within the consultation on how this would be applied. Therefore without further detail, it is difficult to assess the benefits or risks of this option.

→ **How might these apply in the different sectors?**

The overarching goals of the framework must be to incentivise all networks from all sectors to put forward stakeholder focussed business plans to support the major goals of policy makers, consumers and industry. Therefore, all sectors should be incentivised to submit well justified and stakeholder led plans. We note the Ofgem recommendation to exclude fast tracking for Transmission but consideration must be given to incentivisation for this sector absent of a fast track process.

Transmission should be included for fast track if they meet the requirements and there is a stakeholder benefit.

→ **Should we retain the IQI, amend it or replace it entirely?**

Please refer to the response to Q25 above.

Q26 What factors should we take into account when assessing plans for example, under fast-tracking (option 2) or a single business plan incentive (option 3)?

Ofgem now has a number of years' worth of actual costs, workloads, and outputs delivered for all networks. We broadly support the "traffic light" assessment applied during RIIO-1 that takes into account past performance, previous delivery of commitments and quality of the business plan. Assessment criteria must be published in advance to allow networks to respond.

Business plans will contain a number of future workload and output commitments and Ofgem must take into account the past delivery of workloads and outputs in the assessment process to ensure legitimacy of the process.

Our business plans will contain well justified costs and output targets that will be based on stakeholder requirements. Therefore Ofgem must use all of the information at its disposal, coupled with the feedback from the CEGs, and national independent panel to assess business plans.

If a new single business plan incentive is to be introduced, this must be impact assessed and tested ahead of application.

Q27 Do you have any views on the factors we should take into account when deciding how to differentiate efficiency incentives for companies if we do not use the IQI?

The start point is to develop the RIIO-2 performance and cost assessment process. Ofgem must then impact assess the whole package to ensure a package that has an appropriate risk/reward balance but also provides the opportunity for top performing networks to earn higher rewards. If the IQI is not used to differentiate efficiency incentives, then Ofgem will have to use feedback from the consumer panels and strength of evidence within company business plans.

Ofgem should also remember that efficiency incentives must be symmetrical and whilst a number of networks are outperforming, this may not be the case in the future. Therefore, Ofgem must assess the potential additional risks to consumers of changes to the efficiency incentive strengths.

Q28 Is an explicit upfront financial reward required to incentivise companies to submit high quality business plans, in addition to differential incentive rates or sharing factors?

We support the retention of the fast track process and the IQI as stated above. We would not support "double reward." There is no detail on Ofgem's option 3 proposals within the consultation document but we would support a mechanism that has similar properties to the existing IQI and fast track process which do include an upfront financial reward.

Q29 Do you have any views on our proposal to remove fast-tracking for transmission?

The overarching goals of the framework must be to incentivise all networks from all sectors to put forward stakeholder focussed business plans to support the major goals of policy makers, consumers and industry. Therefore, all sectors should be incentivised to submit well justified and stakeholder led plans. We note the Ofgem recommendation to exclude fast tracking for Transmission but consideration must be given to Incentivisation for this sector absent of a fast track process. Transmission should be included for fast track if they meet the requirements and there is a clear stakeholder benefit.

Q30 Do you have any views on how we propose to incentivise better business plans from transmission companies, including removing the prospect of an upfront financial or procedural reward and placing greater reliance on user and consumer engagement and scrutiny?

We support the principle of rewarding quality business plans. All networks should be incentivised to deliver well justified and stakeholder focussed plans.

The Ofgem proposals are at a very high level but recognise that the linkages within the overall package need to be assessed alongside potential amendments to the incentive strengths. We agree that further analysis is required to understand the impacts.

The key, as with the distribution sector is to ensure that Ofgem has a robust cost assessment toolkit as a basis for cost assessment.

ANNUAL REPORTS/REPORTING

Q31 How can we best improve the suite of annual reporting requirements to be as efficient and useful as possible?

We value the annual Ofgem reports on network performance and think the publication of independent reports from the economic regulator is important for stakeholders. We also think Ofgem has made big strides by using summary “infographics” that we also use with our stakeholders.

There are however some key shortcomings of the existing reports that provide misleading and damaging information that is then used against the sector. A few key changes that can be implemented now that would solve these issues are:

- The Ofgem RORE calculation needs to be updated – it is incomplete and misleading with adverse consequences for the legitimacy of the measurement and reporting of performance energy networks.
- The Ofgem report must include more information to differentiate performance, including efficiency comparators. Ofgem has the information to include these within the annual report and this would add value for stakeholders.
- The bill impact is incorrect and does not reflect bills at the detailed network level. We have provided a methodology to Ofgem for this.

- Ofgem could report earlier after the end of a price control period.
- The networks could take the information and provide greater support to Ofgem to help reporting earlier.

We have welcomed the opportunity to provide our own annual report to our stakeholders and we continually shape our reports in response to stakeholder requirements. We will continue to evolve our reports as stakeholders advise us.

Q32 How can we make the annual reports easier for stakeholders to understand and more meaningful to use?

Please refer to our response above. In addition, we could utilise the views of the new Customer Engagement Groups to help shape future reports. Our view is less is probably more.

CHAPTER 7 – FAIR RETURNS AND FINANCEABILITY

COST OF DEBT (PARAGRAPHS 7.6 - 7.28)

Ofgem correctly note in paragraph 7.6 that the cost of debt is a *"significant driver of the cost of network services."* For that reason, the methodology used to set an allowance representing efficient cost should not have any propensity for material windfall gains or losses across individual companies in each sector. If a company raises debt efficiently, the methodology should set an allowance that covers the cost of that debt; no more and no less.

Ofgem pioneered a 10 year trailing market index approach for RIIO-1, which, as it acknowledged in para 7.14: *"assumes that roughly equal tranches of debt are raised over time (i.e. a fairly constant rate of debt issuance)".* Utility companies, particularly small to medium sized utilities, do not raise debt in this manner. The graph shown in paragraph 7.14 reveals the lumpiness of debt issuance.

Therefore, we must disagree with Ofgem's contention in paragraph 7.8 that the *"<u>best</u> approximation for an efficient company's cost of debt is likely to be a <u>trailing average</u> of market rates"* (our emphasis). In paragraph 7.9, Ofgem state that the potential difference between the costs implied by the index and actual costs *"should be an incentive for companies to raise finance in the most efficient manner."* We would agree, provided the index would not be fundamentally flawed due to its inherent assumption of a constant rate of debt issuance of roughly equal tranches. Given companies inconstant debt issuance in terms of timing and amount, the index is systemically biased to create windfall winners and losers. For that reason alone, it cannot be regarded as a legitimate methodology and must be replaced.

To put this into context in the case of WWU, the shortfall (in nominal terms) in the cost of debt allowance against the cost of efficiently raised debt (excluding derivative costs) for the first five years of RIIO-GD1 was £42m, almost twice WWU's incentive income of £21.3m over the same period. For a flawed index methodology to create a windfall loss greatly exceeding income from one the core pillars of RIIO - the use of incentives - is a perverse situation. We do not believe that this was ever contemplated by Ofgem. We must therefore disagree with Ofgem's statement in paragraph 7.12 that *"the indexation of the cost of debt has worked well in RIIO-1."* It may have led to lower allowances to date compared to the prior control period, but that is not the appropriate basis for a test of cost efficiency. The reality to date is that there have been windfall gains and losses at the individual company level, undermining the basic legitimacy of the methodology, which should be replaced.

In paragraph 7.12 Ofgem suggest a high bar of evidence would be required to alter the existing methodology yet in the same paragraph it acknowledges that the construction of the index could be improved.

In paragraph 7.27, Ofgem comments: *"a pass-through of efficient debt costs could work if we could be certain that we can always establish if debt costs are efficient. This is a relatively strong assumption, as companies financing arrangements are only partially transparent."* Ofgem note further that understanding the cost of various finance arrangements make it a difficult task to quantify an efficient cost of debt.

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We strongly encourage Ofgem to re-consider this position in more detail. Any pass-through proposal must, of course, be accompanied by an efficiency test. We recommend:

1. Benchmarking of each debt transaction; past and future. This might be considered too granular and involve too much administrative effort for Ofgem and companies in terms of testing for efficiency. This should not be so. There should be no concerns on data transparency or availability for costs of debt transactions. Most debt raised by UK utilities is done so in competitive public bond markets or institutional private placement markets, where there is an ongoing excess of institutional demand. Here, the pricing is transparent. Further, the cost of each debt transaction (public or private) can be readily determined from disclosures in statutory accounts and, as an additional safeguard, should one be required, Ofgem could readily require the detailed composition of cost for each debt transaction to be reported in the annual RRP and/or regulatory accounts.

2. The debt of most utilities is invariably nominal fixed rate or real fixed rate. The cost of any floating rate portion of total debt should be allowed provided the credit spread of the underlying debt is efficient. An efficient credit spread of any utility debt can usually be determined without much effort.

3. Use of an efficiency test. Necessarily, the pass through must be accompanied by an efficiency test. This test would measure the cost of debt raised against the spot Iboxx index (using the same Iboxx index in RIIO-1 covering BBB and A rated non-financial corporates for plus 10 year debt – this rating range covers the range of issuer and issue ratings in the sector and thus is appropriate) on the day the debt was or will be raised. Companies with leverage in excess of the notional level (currently 65% for RIIO-GD1) when the debt is issued would have the cost of debt allowance reduced on a pro-rata basis to the notional level.

4. Transaction costs must be reviewed and an allowance given. As correctly demonstrated by CEPA (figure 4.3, page 31) it is not the case that utility companies generally outperformed the Iboxx index since 2009 and they note that utilities now form a larger part of the Iboxx index than before, thus making outperformance more difficult. In paragraph 4.8 of their report, CEPA consider that a specific allowance would be in line with good regulatory practice: "first ensuring that the chosen index reflects the actual yields that companies face on their debt, and then to include a separate allowance for transaction costs". They recommend a fixed allowance of 10 bps, to be accompanied by a justification from companies for the presence of these costs. We think this is a reasonable proposal.

5. The current methodology does not compensate for the cost of carry from raising new debt to refinance existing debt in advance of maturity. Well run companies typically ensure that debt maturities are refinanced in advance of their expiry dates to control refinancing risk, to meet liquidity expectations of rating agencies, to support statutory accounting requirements for going concern reviews and to meet licence requirements on adequacy of financial resources. We would recommend a simple flat percentage addition to the allowed cost of debt rate for each transaction to recognise this unavoidable cost.

6. In terms of setting base revenue allowances for the control period, Ofgem could use a forward estimate, or historic average, of the index and apply it to notional debt. The forward estimate or historic average would then be trued up to the efficient cost of debt on each subsequent debt issuance by the network company.

7. Finally, Ofgem should set out a policy stance on derivative transactions. As far as we are aware, the majority of energy sector utilities use interest rate derivatives to manage interest rate risk. Effective management of such risk is relevant to financeability and can materially influence interest cover ratios and credit profile, key areas to Ofgem's company risk assessment in the context of financeability. The current methodologies for RIIO-1 take no account of derivative transactions. We believe Ofgem's stance to date is to disregard derivative transactions from the cost of debt allowance on the basis that decisions taken are a matter for shareholders and not consumers. This is an important area and worthy of consultation to develop a policy position.

Q33 What are your views on the policy objectives that we have defined with respect to the cost of debt?

Ofgem's overall aim is stated as: *"to ensure that a well-run company can access the financing it needs while ensuring that consumers pay no more than they need to."* We support this statement, but, in addition, believe that such a company should provide a reasonable and fair return to investors and recommend that the stated aim be amended to reflect this. This would make the stated aim consistent with commentary in the preceding paragraph 7.1 and subsequent paragraph 7.3.

We consider the four policy objectives guiding the cost of debt methodology (as set out in paragraph 7.11 on page 78 of the consultation document) to be appropriate in general terms. However, they should each be clarified so that they would be applied at the regulated entity level only, and therefore not judged and/or applied at a higher level, i.e. at a sector by sector level basis using average measures.

Our proposals above, of debt pass through at the notional gearing level after passing an efficiency threshold, would meet all four of Ofgem's objectives more effectively than the current index.

In particular:

1. *"Consumers should pay no more than the efficient cost of debt"*

We would add: "and, conversely, to ensure that an efficient network company is financeable, consumers should pay no less than the efficient cost of debt, at the notional gearing level."

Unlike the current index, a pass through methodology as outlined above would deal effectively with the timing and amount of debt issuance.

2. *"The cost of debt allowance should be a fair and reasonable estimate of the actual cost of debt likely to be incurred by a notionally geared, efficient company."*

As noted above, the current methodology does not achieve this objective for each company in part because it does not deal effectively with the timing and amount of debt issuance, and does not compensate for transaction costs and the cost of carry. It therefore results in network companies generating windfall gains or suffering from windfall losses. Our proposals above should result in a significant improvement towards this objective and the removal of those windfall gains and losses.

3. *"Companies should be incentivised to obtain lowest cost financing without undue risk."*

We agree that the methodology applied should contain an incentive to achieve efficiency. However, using a trailing index would impede this, whereas, when measured against the spot Iboxx index for each transaction, to demonstrate efficiency of debt issuance, companies would be incentivised to meet, or exceed, that index, otherwise part of the actual cost incurred would not be allowed for.

4. *"The calculation of the allowance should be simple and transparent while providing adequate protection to consumers."*

We would add: "…and ensures that costs incurred efficiently are allowed for".

Our proposal above would be simpler, and more reflective of actual efficient debt costs at the notional gearing level, as it would not have a trailing index.

Q34 Which option might help to ensure that the approach to updating the cost of debt methodology delivers best value to consumers and why?

We comment on each of the three options set out by Ofgem below:

1. Recalibrating the RIIO-1 indexation policy

The RIIO-1 index is not legitimate as it leads to windfalls gains and losses for network companies. Changes to the index as outlined in 7.14 to 7.18 of Ofgem's consultation document will not lead to sufficient improvement, because they would not fairly deal with historic debt transactions raised efficiently, and the methodology would not be moved onto a spot index basis, creating further windfall gains and losses in the future.

2. A fixed allowance for existing debt plus indexation for new debt only

Please refer to our proposals above for a pass through approach, which would be better as there would be no requirement to set a fixed allowance, and windfall gains and losses would be largely eliminated.

3. Pass through allowance for debt

This is our preferred approach, provided there is a rigorous efficiency test applied. Please refer to our comments above for the rationale.

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COST OF EQUITY (PARA 7.29 - 7.66)

Ofgem states in paragraph 7.52 that the cost of equity will be set much closer to the start of the new RIIO-2 control period. Ofgem further acknowledge in paragraph 7.52 that *"…it is very early in the RIIO-2 process and that the final cost of equity parameters will only be determined, at the earliest, in 2020".* This is as we would expect. However, we are surprised that Ofgem has, at this very early stage, already indicated some estimates (reference: paragraph 7.50) for what it considers to be an *"inherently unobservable quantity."* We think it would have been more appropriate to consult on appropriate principles or policy objectives in the first place, as it has proposed for debt, and for which no estimates have been suggested by Ofgem at this early stage in the consultation process.

We note the comment made by Ofgem's CEO on page 6 of the consultative document: *"…investors should prepare for returns that properly reflect the low level of risk that they face because of our stable, predictable, regulatory framework."* That comment, combined with the comment made in paragraph 7.74, demonstrate an apparent bias towards the setting of allowances in this area.

We do not believe it is appropriate to imply at this early stage that investor returns would be necessarily lower in the next control. The CEPA report on cost of capital is extensively referenced by Ofgem, yet is not expressly endorsed by Ofgem, and contains some important issues which require review and clarification. Likewise, with the United Kingdom Regulatory Network (UKRN) report.

Further, it is an open question as to whether investors and rating agencies would regard the regulatory regime as stable and predictable compared to the current and prior controls by the time RIIO-2 starts. Already, some rating agencies have expressed views in this area which Ofgem - and network companies - will need to monitor very carefully in the lead up to the start of RIIO-2.

Nonetheless, we outline our preliminary views below, and of course we will, through ENA and directly, continue to engage with Ofgem on the approach and methodology that should be utilised in setting the cost of equity appropriately for RIIO-2.

Q35 Do you agree with our proposed methodology to estimate the cost of equity?

Our views at this early stage are:

- We agree the Capital Asset Pricing Model (CAPM) should continue to be used as the basis for estimating the cost of equity.
- We believe the Dividend Growth Model (DGM) should be used as a cross-check on CAPM, subject of course to DGM being applied appropriately.
- In paragraph 7.50 of their report, CEPA suggests a "plausible" range of 3%-5% for the real cost of equity for RIIO-2. We make the following observations:
    - Ofgem notes correctly in paragraph 7.30 that the cost of equity tends to be more expensive than the cost of debt and we trust Ofgem would agree that this is so because equity is inherently riskier than debt. However, CEPA's table on page 71 of their report contains data which would be inconsistent with this, i.e. debt has a higher return than ungeared equity. We ask Ofgem to clarify this position.

- We ask Ofgem to review the real Total Market Return (TMR) indications used by UKRN and to consider if appropriate adjustments have been made for RPI.
- In terms of geared Beta, CEPA recommends a range of 0.7 to 0.8. We have the following remarks:
    - It is well established practice that asset beta gearing and de-gearing should be done at a target gearing level, i.e. at the notional gearing of 65%, and not actual gearing levels. We are not clear as to where Ofgem and CEPA stand on that point.
    - Paragraph 7.49 – Whilst it might be arguable that gas distribution ungeared asset risk could be lower than ungeared asset risk for the average market, it does not necessarily follow that the geared beta for GDN's should therefore be "significantly lower" than the average market geared beta, or indeed below 1. This is due to a difference in the level of gearing, where GDN notional gearing is higher than the market average. Using the mid-point of CEPA's lower and higher bound asset betas of 0.25 and 0.40 respectively, i.e. 0.325, a debt beta of zero, a notional gearing of 65% for the GDN sector, an equity beta of 0.93 would be produced, very close to the 0.9 beta used for RIIO-1.
    - We note the comments made in paragraph 7.47 about non-diversifiable risk: *"if we actually believe that non-diversifiable risk would change only very slowly."* If Ofgem hold that view, then equity beta in RIIO-2 should not be materially different to that in RIIO-1; assuming the same notional leverage of 65% for RIIO-1 and 2.
    - Further, we ask Ofgem to reflect carefully on the direction of travel for non-diversifiable risk for the GDN sector. A common theme, established by Ofgem since its strategy publication in 2017, is that the energy sector generally is facing considerable new challenges and risks. That should impel Ofgem and companies to review the future level of non-diversifiable risks in the context of setting appropriate Beta levels for cost of equity determination. Taking the consultative document as a basis, there are many references to risk and change, including:
        - In the CEO's commentary on page 4,
            - Para 4.1 – re transition to a lower carbon, more decentralised, flexible, dynamic and responsive system,
            - Para 4.1 – re greater challenge in forecasting costs,
            - Para 4.74 – re energy system creating uncertainty in the future demand for gas and the consequent impact on infrastructure,
            - Para 4.82 – re repurposing of the network to accommodate alternative fuels,
            - Paras 5.1 – network companies will be required to think differently about how the network is operating and developed,
            - 5.11 – given the potential scale of energy transition and innovation required. "The challenge is acute around system operability", and
            - Para 8.19 - future of heat and gas decarbonisation

The comments made by Ofgem in each of the above paragraphs do not appear consistent for a sector with a supposedly slowly evolving non-diversifiable risk pattern. Does Ofgem hold the view that non diversifiable risk for RIIO-2 will be the same as for RIIO-1? We ask Ofgem to review why it considers non-diversifiable risks to evolve slowly in light of its comments both in a strategic setting from its strategy publication last year and in this current framework consultation document about the scale of change and risks facing the sector. This matter will be reviewed further in later submissions and exchanges, when Ofgem address risk assessment for cost of equity and finance-ability in more detail. Investors and rating agencies are likely to watch this area carefully as RIIO-2 approaches.

We ask Ofgem to consider the points above and respond to each.

Q36 Do you agree it would be desirable to index the cost of equity?
→ Do you have views on our proposal for indexation?

- Indexation could expose customers to higher bills should gilt yields increase in future. As Ofgem will be aware, real yields have been very low for some time, and may increase significantly in future.

- It is less difficult to arrive at the overall determination of cost of equity if indexation is excluded. As Ofgem note in paragraph 7.59, estimation of the cost of equity should avoid unnecessary subjectivity.

- The case for requiring indexation is weakened by the proposed adoption of a much shorter timeframe for RIIO-2 when compared with RIIO-1.

- Therefore, at this early stage, we do not think a compelling case for indexation has been made.

FINANCEABILITY (PARA 7.67 - 7.88)

Q37 Do you consider there is merit in removing the indexation of the RAV and adopting a nominal return model in RIIO-2?
→ What would be the benefits and drawbacks?

We agree with Ofgem that this would be a major change to the regulatory framework.

We do not believe there is a compelling rationale to make a change of this fundamental nature as it has implications in both the short and long term for customers and network companies with potential for uncertain outcomes.

Q38 Should the onus for ensuring financeability lie with the network operating companies in whole, or in part?

The question suggests uncertainty as to how this important statutory duty should be governed and applied. We are not clear about Ofgem's intentions in this area.

In respect of the GDNs, Ofgem's statutory duty in relation to financeability is found in section 4AA of the Gas Act 1986, which reads:

> *"(2) In performing the duties under subsections (1B) and (1C), the Secretary of State or the Authority shall have regard to:*

….
(b) The need to secure that license holders are able to finance the activities which are the subject of obligations imposed by or under this Part, the Utilities Act 2000, Part 5 of the Energy Act 2008 or section 4, Part 2, or sections 26 to 29 of the Energy Act 2010….”

This can be summarised as meaning that:

- The statutory duty on Ofgem has substantial force.
- It would not be legally valid to place the entire duty on companies, as this would deprive Ofgem’s statutory duty of all legal effect and practical value.
- Ofgem’s duty is limited to the financing of activities that are the subject of regulatory obligations.
- The individual circumstances of each company be taken into account by Ofgem.
- It does not mean that the company is held harmless from inefficiency or default.

Therefore, Ofgem can discharge this duty by ensuring that the company is placed in a position in which it can finance its activities. However, whether the company actually takes the steps necessary to do so is a matter for the company itself.

If the current licence conditions relating to investment grade status, adequacy of financial resources and ring fence protections are not considered adequate, Ofgem should commence work to formulate and publish a policy for its statutory duty on finance-ability and consider how that duty could be discharged through licence conditions. Formulation of policy should involve consultation with stakeholders including publication of any legal advice that Ofgem would receive.

With regard to comments about rating agencies in paragraph 7.81, the content of those discussions should be made public as part of policy formulation. Disagreement or lack of clarity across stakeholders in this important area would be inimical to sound regulatory policy and a stable regulatory environment. We urge Ofgem to progress work in this area and complete it well in advance of final business plan submission in 2019.

Q39 Do you consider the introduction of a revenue floor, to protect the ability of companies to service debt, to have merit?

If a company projected non-compliance with the licence requirement for a BBB- investment grade status based on its business plan submission, it risks losing its licence to operate for that control period. Discussions would be required between shareholders, lenders, rating agencies, and Ofgem to assess options. No doubt those discussions would consider many matters, including shareholder restraint in the prior control(s), track record on rating experience, the protections afforded to lenders by the company, the company’s track record on compliance with regulatory targets and Ofgem’s statutory duty on financeability.

Therefore, we do not think it is necessary to predetermine and define an exact type of financial support such as a revenue floor, because the circumstances of each network company are likely to be unique to it. Indeed, we think it could be counterproductive – if the investment community notes that the regulator is expressing concerns about finance-ability it could increase required returns thus adding pressure on future costs of debt and equity, at the expense of the consumer.

CORPORATION TAX (PARA 7.89 – 7.96)

Q40 Do you agree that Ofgem should review the causes of any variances between tax allowances and taxes actually paid to HMRC (including the treatment of group tax relief)?

We agree that corporation tax is a highly complex area and that Ofgem should review the causes of variances between tax allowances and taxes paid. The policy objectives should be centred on fairness and transparency for this challenging area.

If a tax allowance differs to the tax paid, this should not necessarily mean that a company has experienced a windfall gain or loss. What is important is that Ofgem monitor such differences during a control, understand why they arise and act accordingly. Each annual RRP submission could include a reconciliation of regulatory tax to actual tax, such that Ofgem can monitor and understand the reasons for these differences throughout the price control period.

Ofgem's tax methodology does not replicate tax law and with good reason – it is too complex and it is also unnecessary to do so.

Regulatory taxable profits or losses can differ to actual taxable profits or losses for entirely valid reasons. For example, non-regulated income is not included in regulatory taxable profits, and the allowance for interest (our comments above on the current index should be borne in mind here) is deducted in arriving at regulatory profits whereas actual interest costs are used in arriving at actual taxable profits or losses.

Where tax clawback applies, some costs / income are not included (e.g. fair value movements on derivatives) in clawback calculations, but can be included in arriving at actual tax. Tax clawback was last reviewed by Ofgem as far back as 2009 and is in need of update. The rules outlined in 2009 can result in unfairness. For example, if a certain type of debt does not lead to any tax deductible expense, that debt must nonetheless be included in the Debt to RAV test of clawback. This is clearly not appropriate.

→ **Which of the options described in this consultation may be worth investigating further to address any material variances?**

Ofgem is considering three options for RIIO-2:

A. Notional allowance with added protections,
B. Actual payments to HMRC, and
C. The "double-lock": allowing the lower of notional (option A) and actual (option B).

We support a move to simplification and more transparency, provided fairness is ensured. Some areas require consideration, as follows:

- For example, if the actual tax charge has been reduced by certain types of derivative costs or losses, and which are not compensated in the cost of debt allowance, then it would not be appropriate, or in deed fair, to include those items in arriving at the regulatory tax allowance.

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- Non-formula costs and revenues need to be excluded from the determination of the regulatory taxable income.

- For the avoidance of doubt, in setting the correct amount of tax losses to be brought forward into RIIO-2, any items not included in the determination of regulatory taxable losses in prior periods need to be kept excluded unless they have been compensated through regulatory revenues.

The option of an allowance for the actual tax payments, although it would result in a significant simplification, must therefore require the above matters to be taken into account to ensure fairness. Which means that the current system should be retained but based on an updated policy for tax clawback, combined with annual reconciliation of actual tax to regulatory tax.

OTHER FINANCING ISSUES (PARA 7.97 – 7.102)

Q41 Do you agree that we should move away from RPI for RIIO-2 (including for the indexation of the RAV if retained as a feature)?

Ofgem states in paragraph 7.98 that it proposes to move to CPI or CPIH. No rationale is provided by Ofgem and we note in the CEPA report, paragraph B.1.3, that they highlight some issues in adoption of a CPI linked framework.

Consistent with maintaining a stable and low risk regulatory environment, a separate consultation document should be issued to all stakeholders, including investors, and policy formulation should be based on the following principles:

- Existing RAV should be kept whole from any index change. NPV neutrality for existing investors must be transparent and fair.

- Acknowledgement of the lack of supply of CPI linked debt by the Debt Management Office (DMO) and corporates resulting in an illiquid market in this area.

- Companies with RPI linked bonds and derivatives must not be disadvantaged.

- Because of the significance of the change, it should be signalled well in advance based on comprehensive consultation and sound logic.

- Should apply from the RIIO-3, at the earliest, and not before the Bank of England establishes a liquid market for gilts linked to CPI/CPIH.

→ **If yes, which of the two potential indices – CPI or CPIH – might be most suitable?**

This is of secondary importance to the primary consideration of dealing effectively with any change from RPI. Please refer to our comments immediately above.

Clearly, whichever index becomes firmly established in the capital markets should be preferred in the first instance. CEPA note in paragraph B.1.3 of their report that if an approach is adopted to take account of existing RPI index linked exposures, whilst at the same time as transitioning to a CPI-linked regime. This approach is likely to be relatively complex and difficult for the average consumer to engage with. Hence our proposals above.

→ **Is a phased transition between RPI and the chosen successor index necessary or desirable?**

Please refer to our comments above in answer to Q41.

Q42 In the light of our proposal not to amend, at a price control framework level, our policies for depreciation and asset lives set in RIIO-1 do you have any views or suggestions that you wish to put forward?

Please refer to our response to question 43 below.

Q43 We propose to review the fast/slow money split at the business plan submission stage, do you have views that you wish to put forward at this stage?

The increasing capitalisation of Repex to 100% by the end of RIIO-GD1 results in a significant reduction to fast money over RIIO-GD1, due to the long life depreciation profile of accretions to RAV. In RIIO-GD1, for WWU, fast money is projected to decline in real terms by 36.7% whereas the depreciation allowance increases in real terms by just 20.5%.

The result is that in the final year of RIIO-GD1 the projected aggregate, in real terms, of fast money (excluding TIM) and the depreciation allowance totalling £177.7m will be lower than in the equivalent in the first year of RIIO-GD1 of £208.8m. Although RAV in real terms is projected to grow by 6.6% in total from £1,610m in March 2013 to £1,717m by March 2021, the overall impact of this change is to reduce cash flow generation during the RIIO-GD1 control, with a resultant gradual increasing pressure on interest cover ratios.

As part of RIIO-GD2, the fast/slow money split and the depreciation allowance should be reset to ensure that no further decline in the aggregate of fast money and depreciation allowance occurs.

Q44 Do you think existing mechanisms for providing allowed revenue to compensate for the raising of notional equity are appropriate in principle and in practice?

CEPA indicate an allowance of 3% for the costs of raising new equity in paragraph 5.6 of their report on the cost of capital. We consider this to be reasonable.

ENSURING FAIR RETURNS (PARA 7.103 – 7.143)

We agree with Ofgem's general comments that consumer's benefit when network companies "beat" the cost allowances and output targets, as do the network companies themselves in enhancing the base equity return set within the price control.

We also agree with Ofgem that allowances should only be retained by companies if the output or outcome associated with that allowance has been achieved. This could be through an approach foreseen at the time the control was set, through subsequent innovation or through an alternative approach that wasn't considered when the control was set. Provided the outcome desired when the control was set is achieved then the network company should be entitled to the allowance. Conversely where the outcome hasn't been achieved the network company should be obliged to return the related allowance.

We agree that there is a risk that outperformance (and underperformance) can be caused by effects such as price inflation running lower (higher) than forecast, weaker (stronger) economic recovery and expenditure re-profiling where these are not adequately dealt with in the price control settlement. By using indexation, volume drivers, uncertainty mechanisms and achievement of outcomes appropriately these weaknesses, and any resultant windfall gains or losses to network companies, can be adequately addressed. However, where these mechanisms are used they should be closely defined in advance of the price control being set to ensure there is no subsequent ambiguity.

However, we disagree that the current Return on Regulatory Equity ("RoRE") calculation is a fair measure of the return earned by equity. Ofgem's current RoRE measure, as used so far in RIIO-1, ignores performance against significant elements of the price control settlement. These including performance against debt allowances, pension deficit funding and tax allowances. These shortcomings are acknowledged by Ofgem in their annual reports on network company performance for RIIO-1, and could easily be corrected by the inclusion of these missing elements in the calculation of RoRE used by Ofgem.

In paragraph 7.117 Ofgem states that it will revisit the efficiency incentives used to allocate under and over spend between companies and consumers to better reflect the balance of risks. With a tougher control, already well signalled by Ofgem, comes significantly higher risk that the control will not sufficiently fund the companies to efficiently carry out the activities they are required to perform. The balance of the incentive weighting therefore requires careful consideration to ensure that it achieves the required objectives.

Ofgem sets out a number of potential failsafe measures to ensure that company returns are not higher than expected. We consider that if allowances and uncertainty mechanisms (indexation and volumes drivers etc.) are set appropriately then neither caps on company returns to protect against unintended shareholder benefit nor floors to prevent companies becoming unfinanceable are required.

Given the open and inclusive nature of Ofgem's price setting process to date (including in the setting of RIIO-1), the introduction in RIIO-2 of the companies' Consumer Engagement Groups, and Ofgem's own Consumer Challenge Panel, together with the ability of any interested party to challenge specific elements of the proposed price control settlement with the CMA, there seems to be adequate review to ensure that the RIIO-2 controls are set appropriately. The proposed shortening of the price control to five years, from eight, also significantly reduces the likelihood of forecasting error.

Noting the above, it is not obvious that a failsafe mechanism of any kind is required: application of Ofgem's existing powers can address the root cause and appropriately protect customers and investors against unforeseen events and the risk of "excessive" returns. Also, introducing any such approach necessarily adds to the complexity of the price control, going against Ofgem's stated aim of wanting to simplify future price controls.

The legitimacy of the control can be enhanced by addressing each of the points above and through Ofgem improving its annual RIIO-1 reporting to better differentiate between the performances of the network companies it regulates using the information it already collects. Ofgem sets out five possible approaches to limiting network company returns, these are:

A. A hard cap/floor,
B. Discretionary adjustments,
C. Constraining Totex and output incentives,
D. A RoRE sharing factor, and
E. Anchoring returns.

Should any such mechanism be introduced, careful consideration needs to be given to ensure there are no unintended consequences caused by the particular performance of a company in any year of a control period and the expected performance across the entire control period.

We also note that the introduction of any approach aimed at limiting company returns is unlikely to improve the legitimacy of the control, may impact on the performance of incentive mechanisms within the control, and is likely to result in higher costs to consumers as there is greater risk to equity at the start of the control.
We discuss each of Ofgem's proposed approaches to limiting company returns in responding to question 45 below.

Q45 What are your views on each of the options to ensure fair returns we have described in this consultation?

We are firmly of the mind that a price control should ensure a fair outcome for all.

A number of the measures identified by Ofgem are safeguards in the event that the price control is initially set incorrectly. We would expect that, given the price control is a negotiated settlement performed transparently with the ability for all interested parties to participate, a fair equitable price control is reached.

Therefore, safeguards are only required to deal with unexpected or unforeseen events.

Typically, these are dealt with through uncertainty mechanisms agreed at the start of the control.

Generally, the shorter the control period, the less likely it is that network companies would suffer from windfall and/or price control forecasting errors, or benefit through windfall gains. This supports a move back to a five-year control.

It would not be appropriate to retain an eight-year control and strengthen the mid-period review process, as this would effectively become two four year control periods. This would result in Ofgem, the network companies and other contributors to the price control process being in a near constant cycle of price control setting, diverting significant management effort from running and improving efficient businesses, not to mention the likely additional cost and the high chance of running CMA appeals in parallel. A position none of us would wish for.

In terms of the five specific options put forward by Ofgem:

A. A hard cap/floor, (para 7.124)

Giving ranges within which Ofgem sees returns to equity as being acceptable becomes an arbitrary position and equity investors may see the range as more or less risky than their own appetite and therefore this may change the cost to the consumer in compensating for that risk.

As Ofgem identifies in paragraph 7.124, this approach could significantly diminish the power of incentives (and penalties), limiting the performance of the network companies, such that they stop outperforming once the cap has been achieved. This would increase cost to the consumer above that at which it would otherwise be set.

This would appear to move Ofgem significantly towards rate of return regulation, should the cap and floor be too narrowly defined.

B. Discretionary adjustments, (para 7.125 – 7.127)

We are not in favour of discretionary amendments as these weaken the regulatory settlement and can lead to increased uncertainty during the control period. As with an eight-year control period with a mid-period review, the parameters and scope of the mid period review would need to be precisely defined in advance.

The basis of any discretionary adjustments would need to be consulted upon and agreed in advance of setting the control. It is important to clarify the circumstance in which they would operate. As with these reopeners and negative impact reopeners would need to be very clearly defined and the operation set out. They should also be set with de-minimus levels, as with traditional reopeners to ensure they are only triggered where material differences arise.

Such an approach could dis-incentivise network companies from achieving savings as they are not clear on the share of the savings that will be retained. There is also likely to be increased uncertainty to equity investors, increasing costs to consumers.

Changing targets for incentive payments during the price control, or after the event, would add significantly to the complexity of the control and would dis-incentivise network companies from aiming to achieve them, given the risk of change. This could also lead to an increase in the cost of equity as uncertainty during the control is increased.

(7.127) Using the MPR and the end of control processes as mechanisms for making adjustments would lead to network companies requiring to estimate annually any required adjustments for their RIIO accounts. This could result in material differences in the published RIIO accounts of the network company view of the adjustments compared with Ofgem's view. Consideration would need to be given to how these would be dealt with.

C. Constraining Totex and output incentives, (para 7.128 – 7.135)

Sculpting of the percentage of any out or under performance that a network company retains could be a viable proposal. However, the amount of sculpting would need to be set carefully to ensure that it doesn't discourage the network company from maximising the outperformance it could achieve. This approach should be symmetrical with over spends against the allowance being shared with consumers in the same way as underspends.

We agree with CEPA's analysis in paragraph 7.130 that this is likely to limit the outperformance network companies aim to achieve as there is not an incentive to go beyond the trigger point; increasing costs for the long term to consumers above those that would otherwise be paid.

However, care needs to be taken if only Totex performance and output incentives are considered in the sculpting. Network company performance should be considered against the entire price settlement and not just these limited elements of it.

We agree with Ofgem that network companies should be incentivised to improve consumer experience. Where the experience of the consumer has improved, the network company should be rewarded. We are therefore not supportive of either zero sum or fixed pot incentives. If the consumers of all the network companies have benefitted from improved service, then why should all the network companies not receive an appropriate reward. Conversely if experience for all consumers has deteriorated, then all network companies should suffer a penalty.

Tapering of rewards as set out in paragraph 7.129 could lead to network companies managing the recognition of efficiencies to operate in the higher retained performance bands across the period of the control. This is recognised by CEPA in paragraph 7.130.

We are firmly of the view that the current approach to incentives in RIIO-1, against a fixed ex-ante target, with clear, up front, assessment of the financial impact, where all network companies can earn or suffer from that incentive performance dependent on their own performance against a fixed target incentivises the best performance from those network companies.

The issue Ofgem seems to be addressing is the size of the incentive benefits currently being earned in ED1 and not in GD1. Which can be dealt with by appropriately setting both the target and the financial reward/penalty levels, ex-ante.

This approach also has the benefit of keeping the price control simple, an objective for Ofgem and the network companies.

D. A RoRE sharing factor (para 7.136 – 7.139)

In order for any measure based on RoRE to be acceptable, it is crucial that the measure of RoRE used is complete, encompassing all aspects of the settlement, including performance against debt, pension deficit and tax allowances for example. These items could remain excluded from the RoRE calculation provided they are treated as pass through post the achievement of an efficiency hurdle.

As with the other mechanisms that place limits on returns, the introduction of a RoRE sharing factor could act as a dis-incentive for companies which were outperforming the price control to continue to strive for further outperformance since the rewards from that further outperformance would be reduced. This could reduce innovation and efficiency, and would weaken the case for discretionary investments from which customers also benefit. Moreover, because it would weaken incentives to deliver outputs and cost savings beyond a certain level, it would reduce the ability of Ofgem to challenge other companies to improve their performance at future price control reviews.

A sharing factor already exists through TIM and the IQI, adding a further sharing mechanism on top of this through a RoRE sharing factor just further increases the complexity of the control.

We would agree that this approach warrants further discussion and the key elements to consider are:

- Ensuring an appropriate, complete measure of RoRE is used.

- Doesn't become overly complicated through the addition of a further sharing mechanism on top of TIM and the IQI incentive rate for Totex.

- Ensuring that the approach continues to incentivise network companies to maximise their outperformance opportunities.

E. Anchoring returns (para 7.140 – 7.142).

Anchoring of returns would appear to move towards the American model of regulation, where cost reduction, innovation and consumer service are not as well placed as they are in the UK. This could result in deteriorating customer experience whilst customer bills increase, adversely impacting the legitimacy of the price control.

Applying anchoring in sectors where there are few or even one regulated entity is not straight forward and could lead to unintended outcomes.

We therefore do not support such an approach.

Q46 Is RoRE a suitable metric to base return adjustments on?

→ Are there other metrics that we should consider, and if so why?

As set out elsewhere in our response, Ofgem's RoRE measure, as used currently in RIIO-1 is incomplete including only performance against:

- Base allowed equity return,
- Totex allowances, and
- Incentive income.

It excludes other significant elements of the RIIO-1 price control settlement, including performance against:

- debt allowance,
- pension deficit funding,
- tax allowance, and
- Pass-through items cash flow timing impacts (allowance timing vs actual cash spend).

We are fully supportive of Ofgem publishing a measure to show the relative performance of comparable network companies. However, that measure needs to be complete to accurately reflect the position and enable properly informed judgements to be made.

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This is particularly the case where a new, tougher, control is introduced, and in an environment where the risk of CMA referral on very specific elements of the proposed allowances for RIIO-2 is possible, by a very wide range of interested parties. In these circumstances, it is important that each element of the price control is appropriately set rather than the consideration being given to the price control in the round being acceptable. It is no longer appropriate for perceived generous allowances in some areas being offset by perceived tough allowances in other areas.

Any form of return adjustment limits the ability of equity to earn an increased return based on outperformance, which is shared with consumers, provided those savings are passed on by shippers.

Limiting the returns which equity can earn through outperformance could become a limiting factor on the outperformance achieved by network companies and this would result in consumers paying more than they otherwise would- Provided any savings are passed on by the shippers. We are therefore against any form of cap on the ability of equity to earn additional return for increased efficiency, whilst achieving outputs agreed as part of the regulatory settlement. As this could lead to lower outperformance than would otherwise be the case.

We do though, see some merit in a sliding scale to the amount of any outperformance retained by the equity investors, with a lower share retained the higher the level of outperformance. However, as noted in response to question 45 D above, care must be exercised to ensure multiple sharing factors are not applied, with TIM and the current IQI sharing factor currently being used and the suggestion of an additional RoRE sharing factor on top.

We note that a measure of RoRE which includes all aspects of the price control settlement is a fair reflection of the return earned by equity at the notionally geared network company level.

Should these additional elements be built into the RoRE measure currently reported by Ofgem for RIIO-1, we would expect that there would be some significant changes in the reported position. Some network companies showing increased RoRE and some showing reduced RoRE. We would anticipate that this would largely represent the windfall gains and losses registered by network operators against the cost of debt allowance as measured using a rolling index.

The alternative to recalculating the current RoRE measure, and one we would very much endorse, would be to ensure that over, or under performance against those elements of the control not included within the RoRE measure cannot occur by treating their efficiently incurred cost as pass through.

CHAPTER 8 – NEXT STEPS

Q47 Do you have any views on the interlinkages and interactions outlined in this consultation and those that we will need to consider as we develop our sector specific proposals?

The sustainability and success of the regulatory package for consumers, stakeholders, and investors is dependent on all of the RIIO framework and sector specific elements adding to an acceptable package. We highlight below some key areas that must be considered as we develop the sector specific proposals.

1. **The CEPA review of the RIIO framework and RIIO-1 performance**

We welcomed the CEPA review (noting its limitations) and highlight some key points that should be taken into account before introducing substantial changes to the existing RIIO framework:

- CEPA recognise RIIO-1 was the first time the RIIO principles were used and that they are still in their infancy.
- CEPA also recognise that we now have a number of comparators within gas and electricity distribution that provides the opportunity to use actual information to inform future cost allowances, Output levels, and incentive baselines for future price control resets.
- RIIO has delivered benefits for consumers, incentivised improved performance, stakeholder engagement, and investment.
- Within price control regulation, consumers benefit from “a repeated game” effect and the full benefits of the new RIIO regime would be gained over time and not just through RIIO-1.
- The CEPA review highlighted specific “execution risks” that resulted in different but specific issues for each sector.
- Any new framework principles should be impact assessed before introduction.
- The RORE metric being used to show network returns is incomplete.
- Ex post revenue adjustment mechanisms could result in a “rate based” framework.

The RIIO framework and the GB energy regulatory framework have been held up for a number of years as an exemplar worldwide. As we review the RIIO framework we must remember there is international competition for capital and significant investment uncertainty for Great Britain.

Our takeaway from the CEPA review is that the existing RIIO framework is already overly complex but has a number of high powered incentives and has broadly delivered for a number of stakeholders.

Ofgem has the opportunity to improve the specific issues for each sector by better application of the principles rather than the introduction of a number of new ex post and untested mechanisms which would add more complexity.

Indeed, CEPA's recommendation is that any of the proposed changes should be carefully impact assessed prior to their introduction. We would also require specific consultation once the impact assessment has been conducted.

2. **The overall risk / reward balance**

A number of instruments are discussed within the framework consultation that will change the overall risk/reward balance of the regulatory regime. Each option will have an impact on the overall settlement and we must work through the collective package to fully understand which combinations will promote a sustainable balance for customers, investors and other stakeholders.
The options include:

1. Introduction of new stakeholder groups to strengthen the consumer voice
2. An update to the cost of equity to reflect current market conditions
3. A reduced price control period from 8 years to 5 years
4. Use of uncertainty mechanisms and reopeners
5. Use of specific workload volume drivers where there is not a direct link to RIIO Outputs
6. Greater use of indexation of hard to forecast costs – E.g. Real Price Effects (RPEs)
7. Changes to the Totex sharing incentive – possible increase of risk & reward to customers
8. Reduction in revenue incentives to limit returns
9. Increase in competition to other sectors
10. Possible in-period changes to costs & Outputs/Outcomes to reflect actual performance
11. Ex post "failsafe" mechanisms to restrict levels of return

Our view is that a better application of the existing RIIO framework, updated cost allowances to reflect current efficient levels, and options (1) to (7) above provide significant protection for consumers whilst still incentivising networks to deliver excellence. With a reduced price control period, we are concerned that any additional measures (8) to (11) on top of (1) to (7) will significantly reduce the incentive on networks to deliver excellence and constrain performance.

Ofgem has pressured a number of the networks to make voluntary contributions during RIIO-1 because of Ofgem's reported RoRE's of those companies. We think this is poor regulation which could enable networks to avoid formal regulatory interventions. Our view is that Ofgem has existing powers to intervene when networks do not deliver and that formal powers through the existing framework should be used to return unjustified gains back to consumers. We also require that Ofgem revises its RoRE measure to fully account for performance under the regulatory settlement, including performance against debt and tax allowances.

Overall Financeability

Ofgem has indicated within the consultation (chapter 7) that financeability may be an issue. We have outlined above a number of factors that could give rise to lower revenues & lower cost allowances.

We therefore agree that further work is required to fully assess the financeability of the framework proposals and the sector specific outcomes.

1. **The RIIO framework package and the energy sector appeals mechanism**

There were a number of CMA appeals on the RIIO-ED1 settlements. The appeals mechanism for energy allows an individual party to appeal a specific element of the regulatory settlement. Our investors and key stakeholders will assess the package as a whole but there is a risk that an appeal on a specific element changes the risk/reward and/or the Financeability of the settlement.

This is an area that causes us concern and in order to continue with a "RIIO" package, a review of the appeals process within energy should be considered and would welcome engagement with Ofgem on this issue ahead of RIIO-2.

2. **Incentivisation of efficiency and excellence**

The CEPA review of RIIO and indeed Ofgem's own RIIO-2 launch presentation slides highlighted the benefits of the existing RIIO framework. Two key benefits for consumers have been the focus on cost efficiency and improvement in service, which to a degree is supported by collaboration across networks.

The introduction of "relative" incentives or "Fixed Pot" adjustment mechanisms may significantly reduce the level of collaboration and indeed result in reduced efficiency and service levels. We have seen no evidence to support a move away from the use of absolute incentives.

Q48 Do you have any views on the issues highlighted that we will consider as we develop our sector-specific proposals?

Gas Distribution, Gas Transmission, and Electricity Transmission must submit RIIO-2 business plans in Q3 of 2019. Time is tight and therefore, we must develop the following to enable networks to deliver quality business plans within this timescale:

- We must start on the cost allowance toolkit. We have had several RIIO-2 workshops on returns and customer engagement but the cost allowance toolkit is a fundamental part of the framework. There has been very little activity in this area. If we get this area right, many other aspects of the whole process get solved without the need for other complex and untested mechanisms.

- If the desire is to retain an “Outputs” based regulatory regime with revenues and cost allowances linked to Outputs and Outcomes, we must start to develop the Outputs/Outcomes required for the first group of network companies to go through the updated RIIO framework. Without this, we will not be able to engage effectively with stakeholders.

- We welcome the guidance issued from Ofgem on how the stakeholder groups will be developed but we must build on this now to develop sufficient detail for all parties.

- We must get visibility of how business plans will be assessed as early as possible. This will help networks provide quality business plans and hopefully simplify the process for Ofgem and the stakeholder groups

- RIIO-1 close out. There are mechanisms to “close out” RIIO-1. As we develop the RIIO-2 framework the RIIO-1 close out will drain resources from Ofgem and network companies. We would welcome early discussions with Ofgem and other network companies to develop the RIIO-1 close out timetable and decisions to help mitigate the risk that RIIO-1 close out impacts the quality of the RIIO-2 process.

In addition to the points above, we must develop efficiency comparisons that are currently absent from the Ofgem’s annual reports. There is an opportunity to develop and test the efficiency comparisons that we should use within the RIIO-2 framework– for Ofgem to include in their annual reports ahead of RIIO-2.

Q49 Are there any sector-specific issues or policy areas that we should ensure we review and consider as we develop our sector-specific proposals?

1. Ofgem capability

We note the level of staff turnover and a number of vacancies at all levels within Ofgem.

It is important that the independent economic regulator has the resource and capability to deliver its functions effectively.

The shortening of the price control period and the current level of complexity within the RIIO regime requires a fully functional network team and we trust that Ofgem continues to develop its capability and depth. We will continue to work collaboratively with stakeholders to provide constructive support where we can.

2. How Ofgem gets to grip with whole systems approach

The GB energy system is underpinned by world class gas and electricity networks. Gas currently provides circa 40% of power, 85% heat and a growing proportion of energy for large vehicle transport.

There is a growing body of independent evidence and direction from European policy makers that highlights the requirement for countries to maximise the benefits of whole energy systems thinking.

Ofgem has lost a significant number of "gas specialists" and the systems team has been electricity focussed to date - which is understandable given the large issues on generation and market development.

It is imperative that Ofgem develops its knowledge across each of the sectors it regulates and its whole system thinking, as we move forward if it is to keep up with the challenges outlined in key Government policies such as:

- The Industrial strategy
- The Clean Growth strategy
- The Fuel Poor strategy
- Supporting vulnerable customers and communities
- Regional challenges – E.g.: Wales Climate Change obligations

Q50 Do you have any views on our high-level proposals for timing of RIIO-2 implementation, and on our proposals for engagement going forward?

Time is tight. We have provided responses to Q48 above that highlight some of the challenges - especially for the first set of RIIO-2 business plan submissions.

In addition to these points we need to get started on the role of, and engagement with, the Ofgem independent panel.

The CEPA review has highlighted some of the specific sector issues and the role of Ofgem through the RIIO-1 settlement process and we would welcome early discussions with Ofgem and other stakeholders to apply the learning into RIIO 2.