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2 May 2018.

Sent by email to: RIIO2@ofgem.gov.uk

Dear Jonathan,

RIIO-2 Framework Consultation

Thank you for the opportunity to respond to the above consultation. This is a non-confidential response on behalf of the Centrica Group.

We welcome these proposals. We believe they represent a clear improvement on current arrangements. The consultation provides options which would make the framework likely to be successful in delivering networks that will support our future energy needs, at a fair cost to customers. The following areas are key to designing an effective framework:

- Price controls should deliver good value for money for consumers:
 - Mechanisms, including failsafe protection, are required to ensure only genuine outperformance is rewarded.
- The framework should be able to accommodate the energy transition economically and efficiently:
 - Arrangements should reflect the changing energy system, allowing whole system solutions across both gas and electricity, and require both innovation and the use of flexibility services.
- Stakeholders should be able to effectively engage with the process:
 - In addition to the enhanced stakeholder engagement proposed for the networks, a dedicated working group should be convened for the development of Ofgem's sector-specific proposals.

Value for money:

We remain of the view that price control arrangements should reflect the purpose of network regulation: to mimic competition. This means the allowed cost of equity should reflect the return to be expected from an average network and network company returns should be symmetric around this baseline i.e. not all networks can outperform. We calculate the value of the reported

outperformance under the RIIO-1 price controls, compared to if returns were dispersed around the baseline, to be around £5.6bn¹.

In practice, we believe the following options within the proposals should be adopted to ensure that RIIO-2 is effective:

- Indexation should be employed whenever appropriate, to avoid forecasting errors.
- Similarly, volume and revenue drivers should be employed whenever appropriate, to ensure expenditure allowances automatically adjust to changes in circumstances.
- Incentive targets should be set to reward relative performance, either on a zero-sum basis or with rolling targets that update as performance is revealed.
- A 'failsafe' mechanism should be introduced that will correct general outperformance if it continues. Our preference is for 'anchoring' as it is the only option that directly resolves the issue of general outperformance.

The energy transition:

Arrangements to facilitate whole system solutions are important and should reflect the best solution for customers overall. Networks will need to be innovative and make use of flexibility services in the future. We suggest networks are required to demonstrate that alternative solutions have been considered, both in producing business plans and in delivering solutions.

Significant innovation funding has already been provided. Networks should report on the costs and benefits of the roll-out of solutions trialled. This will assist Ofgem's assessment of efficiency, which should ensure that ideas successfully trialled are fully recognised in expenditure allowances. We support the proposal that innovation funding should be directed towards facilitating the energy transition. Supplementary to this, funding should be provided only for projects delivering genuinely new learning.

Stakeholder engagement:

The role of stakeholders is strengthened with these proposals. We recommend this is enhanced further by the creation of a Stakeholder Working Group, to shadow the more technically-detailed Ofgem-network company working groups. CEPA's analysis for Ofgem on RIIO1 identifies that one of the key failings was the Interruptions Incentive Scheme in RIIO-ED1². British Gas flagged the issues now recognised by CEPA during the RIIO-ED1 consultation process³. This clearly demonstrates the value stakeholders can bring in the detailed part of price control development.

The answers to the detailed questions are below. Please contact me if you have any queries.

Yours sincerely,

Andy Manning
Director - Network Regulation, Forecasting and Settlements
Centrica Regulatory Affairs, UK & Ireland

¹ 2016/17 prices, based on RORE forecasts included in Ofgem's 2016/17 RIIO Annual Reports.

² "Review of the RIIO framework and RIIO-1 performance", page 19:

https://www.ofgem.gov.uk/system/files/docs/2018/03/cepa_review_of_the_riio_framework_and_riio-1_performance.pdf.

³ The British Gas response to "RIIO-ED1: Draft determinations for the slow-track electricity distribution companies":

https://www.ofgem.gov.uk/sites/default/files/docs/2014/10/british_gas_response_to_draft_determinations_consultation_0.pdf.

Appendix – responses to consultation questions

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?

We welcome the proposals to strengthen the role of stakeholders in shaping companies' business plans. Stakeholder involvement can benefit price control reviews in a number of ways, including mitigating the information imbalance between the companies and Ofgem and ensuring the arrangements mimic competition.

The realisation of the benefits of the Customer Challenge and Users Groups to price control reviews is heavily dependent on the perceived and real independence of the groups from the companies. We agree robust governance arrangements are needed to ensure those groups operate at arm's-length from the companies⁴. It is necessary to consider which parties are most appropriately placed to develop those governance arrangements.

In an ex-post review of the operation of the Customer Challenge Groups during the PR14 review in the water sector, several members suggested information presented by the water companies was not neutral (though they accepted their responsibility was to identify and challenge any bias)⁵. We note the companies will be responsible for providing the Groups with information such as performance data, forecasts, etc. and for contextualising the information⁶. It is necessary that the companies and Ofgem consider how this can be achieved without bias, especially since this will be the first time such Groups are convened to support energy network price control reviews.

While we support Customer Challenge and Users Groups being convened to inform and challenge companies' business plans, stakeholders should also be involved in the development of the sector-specific frameworks and detailed arrangements. In its review of the RIIO-1 price controls, CEPA highlights the calibration of the Interruptions Incentive Scheme (IIS) as a source of returns not proportionate to performance improvement⁷. CEPA also notes British Gas referred the calibration of the IIS to the Competition and Markets Authority (CMA)⁸. This demonstrates the benefits of involving stakeholders in the development of the detailed proposals.

We recommend the proposals should be further strengthened by creating Stakeholder Working Groups, to 'shadow' the more technically-detailed Ofgem-network company working groups. Ofgem could use these forums to explain the detail of key aspects of the price control currently under debate. This would provide stakeholders with a better understanding of the relevant issues which, in turn, could allow them to better challenge individual company's proposals. This could allow stakeholders to provide feedback and challenge on aspects of the price control frameworks

⁴ "RIIO-2 Enhanced Stakeholder Engagement Guidance – Version 1", para 2.21:

https://www.ofgem.gov.uk/system/files/docs/2018/04/riio-2_enhanced_stakeholder_engagement_guidance_v13_final.pdf.

⁵ "Customer Challenge Group process: Review of lessons learned", page 30:

<https://www.ccwater.org.uk/wp-content/uploads/2014/07/Customer-Challenge-Group-process-Review-of-lessons-learned2.pdf>.

⁶ "RIIO-2 Enhanced Stakeholder Engagement Guidance – Version 1", para 2.1.

⁷ "Review of the RIIO framework and RIIO-1 performance", page 19.

⁸ British Gas Trading v. The Gas and Electricity Markets Authority:

https://assets.publishing.service.gov.uk/media/55102d72ed915d1424000016/British_Gas_Trading_Ltd_n otice_of_appeal.pdf.

to be developed, to be referred to the detailed working groups. It would also ensure stakeholders are better informed to participate in Open Hearings.

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 proposal to have Open Hearings as they could be another means by which the information asymmetry between Ofgem and the companies can be reduced. We also agree other stakeholders should be given the opportunity to participate. Further, having Open Hearings are another way to improve transparency and engagement with the process. It would be useful if Ofgem could give stakeholders plenty of notice and issue in advance a high-level, non-technical overview of the issues at stake. This would encourage maximum participation by consumer organisations and other interested parties.

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?

The length of the price control is just one of several interrelated factors to be considered when designing price control frameworks. The optimal length of the price control cannot be decided in isolation, but the overall framework, including the length of the control, should be seeking to optimise the cost of capital. Shortening price controls is a means of mitigating risks associated with forecasting errors. The greater use of tools such as volume drivers, indexation and other uncertainty mechanisms can also mitigate risks associated with forecasting errors. However, we recognise that the energy industry is in a period of change. A shorter price control with the ability for the networks to ask for a longer settlement in certain areas, where justified, is a sensible compromise.

What type of cost categories should be set over a longer period?

It may be appropriate to set expenditure allowances for some investment programmes over a longer period. The criteria to identify those programmes should be carefully defined. Some criteria could include:

- The need for investment should be certain e.g. arising from legislation.
- The cost of investment can be quantified and easily 'ring-fenced' within the price control framework.
- There should be clearly defined price control deliverables associated with the allowances, along with milestone delivery targets.
- The impact on other mechanisms within the price control can be normalised e.g. impact on performance against incentive mechanisms.
- There should be benefits to consumers to setting the costs over longer periods instead of resetting periodically.

Additionally, mechanisms that capture the impact of ongoing efficiencies and the rollout of newly-developed techniques on expenditure requirements should be designed.

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?

If eight-year controls are retained, we recommend the MPR scope is widened so that a broader range of issues that are not meeting consumers' needs can be rectified. Nevertheless, our preference is for five-year price controls with the ability for the networks to ask for a longer settlement in certain areas, where justified (see response above). Regardless of the length of the price control, greater use should be made of tools such as volume drivers, indexation and other uncertainty mechanisms.

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?

The current price control framework restricts each company to manage the assets within its individual licence area. Elements such as each company's business plan, expenditure allowances, outputs and uncertainty mechanisms are all linked to delivery within its licence area. This may act as a barrier to the delivery of whole system outcomes.

To overcome this barrier, the price control framework should be adapted to allow for the normalisation of expenditure allowances and outputs, in response to 'out-of-area' requirements. Broadly, a company that delivers investment to solve 'out-of-area' problems should be remunerated at the efficient level of costs for doing so. Similarly, the output targets that form part of the company's price control settlement should be adjusted so that solving an 'out-of-area' problem has neither a positive nor negative impact. There may also need to be adjustments to the allowances and outputs of the 'receiving' network to ensure that consumers do not fund both networks for the delivery of the same output.

It would be helpful, in our view, to ensure that System Operator (SO) remuneration under RII0-2 is as far as possible separate from the network owner price controls, such that SOs are encouraged to adopt a whole system perspective, without undue regard to the possible impact on network owner remuneration (see response to Q6 below).

What elements of the price control should we prioritise to enable whole system outcomes?

It is expected that the future electricity system will require more flexibility services⁹. Flexibility is likely to become increasingly important in delivering optimal whole system outcomes, so it is essential we have aligned positions and processes between the electricity SO (ESO), DNOs, Suppliers, Generators, Consumers and other flexibility stakeholders on how to manage this increase in system flexibility.

⁹ "A Smart, Flexible Energy System – A call for evidence":

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/576367/Smart_Flexibility_Energy_-_Call_for_Evidence1.pdf.

Reliable provision of information will be key to enabling whole system outcomes. The ESO and DNOs (or DSOs) should both have a responsibility for providing a set of standardised and timely information and support to market participants at their respective network levels. The provision of information could form a licence condition minimum standard for the relevant parties.

The Networks Outputs Assessment (NOA) process, introduced to find optimal solutions in transmission, could be a starting point for designing a model to enable whole system solutions. We acknowledge the SO is already investigating how the NOA approach can be extended to include a wider range of market participants, such as storage providers¹⁰. To ensure non-traditional solutions are considered, as a part of this process, it could be a requirement that credible alternatives to traditional network reinforcement are sought and assessed. How this assessment is made will need to be carefully considered and clearly defined. For example, a cost-benefit analysis must consider appropriate lifetime costs to the consumer and the ability of a new resource to facilitate competition, which ultimately lowers whole system costs. We also recommend a wider range of network issues other than capacity constraints are considered in the NOA.

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 believe it is neither practical nor necessary to align the start dates for the electricity transmission and electricity distribution price controls. We are also concerned that extending the current transmission price control (to align the start dates of the next electricity transmission and distribution price controls) would result in the companies continuing to receive undeserved returns.

Instead, price controls across sectors can be made compatible, to facilitate the delivery of whole system outcomes. Already, incremental changes to regulatory frameworks have been made to support this objective. For example, the overall regulatory framework for the ESO was adapted to facilitate the delivery of whole system outcomes¹¹. Therefore, we support the proposal to carry out a comprehensive cross-sectoral review of the key areas relating whole system outcomes.

**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 agree with the definition provided for ‘whole system outcomes’ within these proposals – to ensure that the energy system as a whole is effectively coordinated to deliver best value for consumers¹². How the energy system develops will clearly be affected by other sectors and so understanding these potential scenarios will guide the whole systems outcomes for the energy system.

It is essential to ensure that whole system outcomes are optimal from the perspective of the customer. Ideally, this means the lowest customer cost is also the lowest system cost. Due to

¹⁰ “Network Options Assessment 2017/18”, page 14:

<https://www.nationalgrid.com/sites/default/files/documents/Network-Options-Assessment-2017-18.pdf>.

¹¹ “The Electricity System Operator Regulatory and Incentives Framework from April 2018”, para 1.14:

https://www.ofgem.gov.uk/system/files/docs/2018/02/policy_decision_on_electricity_system_operator_regulatory_and_incentives_framework_from_april_2018.pdf.

¹² Consultation document, para 4.26.

differing sharing factors (the amount of under-spend retained by companies) this is not necessarily the case. It is likely that a combination of minimum standards (for example, relating to information provision) and commercial incentives will be required to facilitate whole system outcomes.

We are also aware that the precise model for future electricity distribution SOs is not yet fully defined. Whilst this is largely outside the scope of this consultation, Ofgem should ensure that RII0-2 allows only the recovery of efficient SO costs (for which a single electricity SO might be a useful benchmark), irrespective of the SO model which may actually be adopted in future. If network companies were to adopt a model which is not least cost, then the additional burden should not be allowed to fall on network users and customers.

System Operator price controls

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

We agree that National Grid's (NGET's) electricity SO price control should be separated from its TO price control. The regulatory framework for the ESO was recently adapted to encourage it to proactively respond to system challenges and to ensure there is a coordinated approach to system operation and planning¹³. The nature of the current 'integrated' price control could encourage NGET to optimise investment across the TO and SO functions instead of across the electricity system. Making internal trade-offs may be a barrier to the ESO considering the full range of system solutions¹⁴. The integrated price control may also encourage the ESO to adopt behaviours that optimises rewards from incentive mechanisms for NGET, instead of the desirable behaviours of a stand-alone SO. The separation of the price controls may better allow the ESO to facilitate the evolution of the energy system and the delivery of whole system solutions. Further, the separation will complement the legal separation of the ESO within the NGET group.

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?**

Due to the nature of the ESO, with a relatively low regulatory asset value and therefore returns, alternative remuneration models and the appropriate level of revenue that should be put at risk should be considered. This is particularly true with an independent system operator.

¹³ "The Electricity System Operator Regulatory and Incentives Framework from April 2018", page 4.

¹⁴ "Initial Proposals for electricity SO incentives from April 2017", para 5.18:

https://www.ofgem.gov.uk/system/files/docs/2016/12/initial_proposals_for_electricity_so_incentives_from_april_2017_2.pdf.

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?

Increasing the use of uncertainty mechanisms, including volume and revenue drivers, should reduce the risk of asset stranding. This approach has already been employed in circumstances where the need for and/or the quantity of investment is uncertain. For example, an uncertainty mechanism was included in the ED1 price control to allow DNOs to justify the need for additional expenditure allowances for link boxes¹⁵, whilst the Strategic Wider Works approach in RIIO-T1 has helped to ensure investment only occurs when it is certain it is required¹⁶.

There should be a higher threshold to justify traditional investment in RIIO-2 and we agree that network companies should be required to demonstrate how they have considered various alternative solutions to justify spending requirements. Using shorter payback periods for the purposes of appraising traditional investment could encourage networks to consider more opex-based solutions. However, we are not convinced of the benefits of using a front-loaded depreciation profile. This doesn't change the risk of an asset becoming stranded or underutilised, but rather simply recovers more of the cost from current customers. To the extent lower future utilisation may increase the effective unit rate (i.e. p/kWh) applicable to users in future years, ultimately the annual cost per customer (i.e. £/cust/yr) will be relatively predictable and stable for any investment undertaken irrespective of the level of utilisation.

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?

Companies, including SOs, should remain focussed on their core role: the efficient provision of energy networks, both now and in the future. This necessarily involves identifying and taking account of the drivers of the need for investment in energy networks (usually usage during peak times) in the most efficient ways. Also, companies are obligated to develop use of system charging methodologies that reflect the costs (and benefits) that users place on the system. The price signals produced by those methodologies are meant to encourage the efficient use of networks and, by extension, encourage companies to incur efficient levels of investment.

Network companies are unlikely to be better placed to encourage energy efficiency because they do not have the relationships with customers that other sector participants do, such as suppliers. Further, several energy efficiency initiatives are funded through customers' energy bills. For example, the Government is currently consulting on the 2018-22 Energy Company Obligation,

¹⁵ "RIIO-ED1: Final determinations for the slow-track electricity distribution companies", para 6.10-6.11: https://www.ofgem.gov.uk/sites/default/files/docs/2014/11/riio-ed1_final_determination_overview_-_updated_front_cover_0.pdf.

¹⁶ For example, see "RIIO-T1: Final Proposals for National Grid Electricity Transmission and National Grid Gas", 4.142-4.146: https://www.ofgem.gov.uk/sites/default/files/docs/2012/12/3_riiot1_fp_uncertainty_dec12.pdf.

estimated to cost about £640m per year¹⁷. The current system of collecting energy policy costs via energy bills is not means-tested and is regressive. As such, we have recommended all policy costs should be funded through less regressive mechanisms, such as general taxation¹⁸. Expanding the role of network companies to include energy efficiency and, therefore, requiring funding through network charges would increase the amount of funding for policy measures recovered through regressive means.

Chapter 5 - Driving innovation and efficiency

Innovation

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 agree with the proposal to retain dedicated innovation funding, targeted to projects that might not otherwise be delivered under the core RIIO-2 framework. We note Poyry's finding (in the review of the Low Carbon Network Fund) that, for networks to move into a 'high' status, innovation needs to be critical to the business¹⁹. This is not possible while innovation support is provided. However, we recognise that significant levels of innovation will be needed to facilitate the transition to a decarbonised and decentralised energy system. It may be appropriate to target innovation funding to support the energy transition.

We also agree that consumers should not fund innovative measures that companies should undertake as a matter of course.

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)?

It is important that certain aspects of innovation are recognised as business as usual activity. For example, active network management is now business as usual. This makes it likely that remaining innovation will be related to the energy transition.

We agree with the three broad areas of reform. It has been recognised by the companies that third parties increased the breadth of innovation²⁰. Recent changes to the governance of the Network Innovation Competitions were made to increase third party participation²¹. However, to

¹⁷ In 2017 prices. "Energy Company Obligation ECO3: 2018-2022" para 9:
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/696448/ECO3_consultation.pdf

¹⁸ See <https://www.centrica.com/news/centrica-sets-out-proposals-deliver-fairer-and-sustainable-energy-deal-customers>.

¹⁹ "An Independent evaluation of the LCNF", page 106:
https://www.ofgem.gov.uk/system/files/docs/2016/11/evaluation_of_the_lcnf_0.pdf.

²⁰ "An Independent evaluation of the LCNF": page 29.

²¹ "The network innovation review: our policy decision", para 2.35-2.38:
https://www.ofgem.gov.uk/system/files/docs/2017/03/the_network_innovation_review_our_policy_decision.pdf.

maximise the effectiveness of dedicated innovation funding, providing third parties with direct access should be reconsidered²².

Innovation funding should also be more readily available to third parties. Parties with a good idea should be able to submit it in the same way that a network company does and where the idea is seen as worthy of progressing, Ofgem should be able to mandate a network company to progress the project. One of the perceived biggest barriers to progressing towards a smarter grid is that the DNOs hold access to funding. It is conceivable that ideas are being limited because the funding for trials is ringfenced rather than being more inclusive. Whilst the Sandbox is open to other parties, we see this as more about business models whereas our view is that there is much to do on the development of a smarter grid so there may be some value in widening the pool for ideas.

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?**
- (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)?**
- (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?**

We support the proposal that innovation funding should be directly towards facilitating the energy transition. Supplementary to this, funding should be for projects delivering genuinely new learning on the basis of broad stakeholder engagement, as mentioned above. For example, significant funding has been provided already for hydrogen related projects so the additional learning from new hydrogen related projects needs to be clear. Another important example is innovation designed to ensure effective and efficient use of electricity network capacity as demand for electric vehicles takes off.

We support Ofgem's recent approach in the Network Innovation Competition, where networks with similar projects were required to work together, reducing overall funding²³. In terms of projects for which innovation funding is sought, we recommend Ofgem continues to take a holistic approach to assessing applications and place conditions on networks to collaborate when similar issues are being investigated. We do not see any conflicts between obliging networks to collaborate in the area of funded innovation projects, whilst allowing them to compete in other areas of the price control (e.g. zero-sum incentives).

Q14 What form could the innovation funding take?

- What would be the advantages and disadvantages of various approaches?**

Funding should allow and encourage 'whole system' innovation i.e. projects that potentially involve both gas and electricity. It is important that the funding approach allows such projects to

²² We acknowledge this will require changes to primary legislation.

²³ "Network Innovation Competition 2017 Funding Decisions", para 3.24-2.28:

https://www.ofgem.gov.uk/system/files/docs/2017/11/decision_on_nic_funding_2017.pdf.

be assessed for overall viability, rather than being required to be viable separately for both gas and electricity.

Some substantial projects have been funded through the Network Innovation Allowance (NIA). The NIA is explicitly aimed at small projects, with the level of regulatory oversight and governance appropriate for this. If the NIA is maintained, only smaller projects should be allowed (or increased oversight if larger projects are to be allowed).

Q15 How can we further encourage the transition of innovation to BAU in the RIIO-2 period?

A number of the wider reform options proposed (zero-sum incentives, anchoring) mean networks needing to compete against each other to secure a desired level of return. This competition is likely to drive innovation compared to current arrangements.

- **How can we develop our approach to the monitoring and reporting of benefits arising from innovation?**

Networks should be required to report out, on an ongoing basis, on the roll-out of technologies trialled under the innovation funding regime. This should record roll-out costs and benefits, by project/technology, and expected total costs and benefits. This will allow stakeholders to understand the effectiveness of innovation funding and also allow Ofgem to make comparisons between network companies.

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 with the proposal to extend the role of competition.

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?**

We have not identified any reasons why the current criteria should not apply. We are unsure, in practice, of whether many projects would be captured under the criteria. It is worthwhile, therefore, considering if the value used in the high value criteria could be reduced. Ideally, this value should be set at the point at which the expected benefits of a competitive approach outweigh the costs.

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?**

The Network Options Assessment process introduced in transmission could be a starting point for developing models. Network companies would be obliged to provide the necessary information to allow assessment of solutions. A system operator would have responsibility for identifying the most appropriate solution.

Chapter 6 - Simplifying the price controls

Our approach to setting outputs

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

With respect to company specific price control deliverables, we agree that there should be a clear methodology to set out what happens if an output or input activity is not delivered, delivered late, or is delivered to a lower or different specification. It is not possible to anticipate every possible reason for a change in delivery and so the methodology should be principles based. It should allow networks to manage output delivery with a good level of regulatory predictability.

We believe the following principles should apply:

- There should not be any rewards for over-forecasting.
- The assessment of network outputs/input activity should explicitly consider both efficiency of the investment decision and customers' best interests i.e. the efficiency test should be from the customers' perspective, not the networks.
- The incentive regime should differentiate between the rewards available for realising genuine efficiency improvements i.e. delivering a specified output at lower cost, and the rewards available due simply to changes in circumstances which mean the investment was not required or could be delivered at significantly lower cost i.e. due to 'good luck'.

With respect to the proposed approach of specifying minimum standards through licence obligations and setting output delivery incentives for performance above the minimum standards, we believe this has the potential to provide greater clarity over what has been funded through base revenue allowances. However, more clarity on the proposed approach is needed and much depends on the definition of 'minimum standards'.

One possible interpretation of 'minimum standards', as may be implied by paragraph 6.13 of the consultation, could be the absolute bare minimum level of service necessary – performance below which is so poor that it constitutes a breach of licence that requires enforcement action.

We would expect that networks are already performing above such a standard across most, if not all, output categories. Observed cost levels will therefore include the costs of delivering this higher level of performance and it would be difficult to strip these costs out to ensure the benchmarking of efficient costs is reflective of delivering only the 'minimum standard'.

This approach would also imply that incentives for service improvements would then use targets set at this minimum standard, as may be suggested by paragraph 6.18 of the consultation. However, these targets are likely to be well below prevailing observed levels of performance. This

would not be appropriate as the observed levels of performance, which will have been rewarded through RIIO-1, can be expected to have been delivered at below the marginal incentive rate. Therefore, to set targets at a minimum standard level would reward networks twice for the same improvements. This would also be inconsistent with paragraph 6.20 of the consultation, which suggests targets will be set taking full account of historical performance.

An alternative approach would be to set 'minimum standards' at a level that fully incorporates revealed performance in RIIO-1. This different interpretation of minimum standards, more akin to a baseline, may provide less obstacles when benchmarking efficient costs, and may also provide a more appropriate starting point for incentive targets. Assuming these were set at stretching levels for an efficient network, we would expect several companies to be performing below target, at least initially. In this scenario, penalties through an incentive mechanism is a more appropriate route than penalties through enforcement action.

Regardless of whether 'minimum standards' implies the bare minimum service level or a revised baseline reflective of revealed performance, there is a lack of clarity over how the proposed approach will be compatible with any truth telling incentive. If networks' returns are maximised by submitting truthful business plans, then they should include expenditure for service improvements that can be delivered below the marginal incentive rate. By way of example, this approach is illustrated in the Northern Powergrid March 2014 Business Plan for RIIO-ED1:

*"Using this portfolio of solutions our analysis suggests that 20% improvement in restoration times is consistent with the cost-effective level of expenditure using the 2015-23 incentive rates set on behalf of all customers. It is possible to make further gains than we plan to, but we believe this would be inefficient."*²⁴

The design of the interruptions incentive scheme is such that if improvements can be made at below the marginal incentive rate of the scheme then a network company will be incentivised to invest to deliver that improvement. However, when combined with the truth telling properties of the IQI incentive, it follows that a profit maximising network company will also include this planned expenditure in its Business Plan. Following this approach, Northern Powergrid included expenditure in its RIIO-ED1 Business Plan to improve restoration times where it was cost-effective to do so, as measured against the marginal incentive rates, and as a result stated that it expected to perform better than the Ofgem targets.

Assuming all networks adopt such a profit maximising approach to output delivery, it is unclear how Ofgem will be able to normalise efficient base revenues to ensure that they do not include funding to deliver service improvements which will also be rewarded through the output delivery incentives. The CEPA report on RIIO-1 emphasises the importance of understanding what has been funded through base allowances when designing incentive schemes²⁵.

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

The RIIO framework should be looking to mimic competition wherever possible and so performance should be assessed relative to other networks. The exact approach could vary by incentive scheme. Some should be designed to be at no overall cost. The Broad Measure of Customer Satisfaction (BMCS) should be zero-sum (subject to a minimum standard) since, in a competitive market, it is improvements in customer service relative to competitors that will bring

²⁴ "Annex 2.1: Reliability and Availability", page 8:

http://www.yourpowergridplan.com/som_download.cfm?t=media:documentmedia&i=1716&p=file.

²⁵ "Review of the RIIO framework and RIIO-1 performance", page 51.

rewards. Under RIIO-1, BMCS is currently expected to give rewards to all network companies, totalling £525m²⁶ over the RIIO-1 price controls.

In other areas, such as reliability and availability, absolute incentive scheme targets could be used but updated on a rolling basis, or could be reset at certain points during the price control period, to capture revealed performance and ensure that overall rewards do not deviate from a broadly symmetric distribution for too long. This would allow the price control to react to changes in a similar way to a competitive market and would avoid the current situation in the RIIO-ED1 Interruptions Incentive Scheme where targets fixed at the beginning of the price control will result in the networks receiving £647m²⁷ in rewards for no improvement in performance.

Designing incentives to reward relative performance, either at an overall or individual incentive level, will also manage the issue of information imbalance. Networks can no longer benefit as a group for any information imbalance and so should focus analytical resource into getting the 'right' solution. Network companies may have differing ideas of what the right solution is, which would create a tension that improves the rigour of the final arrangements. Including a baseline minimum standard, fully reflecting revealed performance in RIIO-1, would also act as a barrier to networks ceasing to seek improvements.

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

Automatically resetting targets by re-running the methodology used to set initial targets for the sector would capture revealed performance, allowing the price control to react to changes in a similar way to a competitive market. Output delivery incentives which have been set using absolute targets should be automatically reset on a rolling basis, or at pre-defined points in the price control to capture revealed performance. This should not impact on the behaviour of networks so long as the marginal incentive rate is maintained and caps and collars are not expected to be reached.

Our approach to setting cost allowances

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

We agree that experience in RIIO-1 has highlighted a need to protect consumers from paying for costs that are assumed to be required, but which then do not materialise.

Risks should be allocated to the parties best placed to manage them. The use of uncertainty mechanisms is appropriate when potential changes in circumstances are genuinely beyond networks' control, and we believe there was a misallocation of risk in RIIO-1 i.e. providing networks with fixed allowances for elements of the price control over which they have little control. Allocating a larger share of uncertain cost allowances to uncertainty mechanisms will help to maximise the efficiency of risk allocation in RIIO-2 and this should also reduce the cost of capital.

We are therefore supportive of the greater use of:

- indexation for uncertain costs where possible.
- volume drivers where volumes are difficult to predict but unit costs are stable.
- revenue drivers or within period mechanisms (e.g. Strategic Wider Works), where there is uncertainty over the scope of work and the costs are significant for consumers.

²⁶ 2016/17 prices, assuming performance is held at 2016/17 levels

²⁷ 2012/13 prices, assuming performance is maintained at 2014/5 levels.

- competition, where appropriate.

For ‘repeatable’ cost activities (e.g. opex, asset replacement or refurbishment), where the costs are within the control of the company and Ofgem can benchmark allowances, we agree that upfront cost allowances with incentives to drive down costs remain appropriate. However, it is important that the outputs framework is robust and ensures networks are not rewarded for over forecasting or due simply to changes in circumstances which mean the investment was not required or could be delivered at significantly lower cost i.e. due to ‘good luck’.

We also believe that where appropriate Ofgem should take a long-term view of costs where network companies’ activities span price control periods. As highlighted in the CEPA review, this is a particularly pertinent issue for repex in RIIO-GD2²⁸ and Ofgem should consider using a workload profile for RIIO-GD2 that accounts for the assumed, rather than actual, repex profile for RIIO-GD1. This would protect customers from cases where GDNs prioritised lower-cost work in RIIO-GD1 and left the higher-cost work for RIIO-GD2.

In our response to the Mid-Period Review Parallel Work consultation, we highlighted a similar issue relating to Cadent’s offer to refund £53.9m to consumers in RIIO-1 in return for deferring a large portion of the required output (replacing medium pressure iron mains in London) to future price controls²⁹. It is important that customers are not disadvantaged by the decision to accept that offer by being asked to fund the deferred output at higher cost in RIIO-2.

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

We are supportive of the intention to index RPEs. Many of the components of RPEs are volatile and difficult to forecast and therefore Ofgem are not well placed to accurately forecast an appropriate fixed RPE assumption for a price control period. As has been recognised by Ofgem³⁰, and by the CEPA review³¹, the decision to allocate the risk around RPEs to network companies in RIIO-1 has led to significant additional returns so far in RIIO-1.

Whilst networks may have some ability to manage some input costs through contracting and hedging, they have little control over market movements in the costs of labour, materials and equipment and so are exposed to these external risks. We acknowledge that indexing RPEs moves the risk to consumers, but given Ofgem are not well placed to forecast RPEs, and networks not well placed to manage the external risk, we feel this is appropriate. As has been recognised by CEPA, this should also reduce the networks’ cost of capital:

“As the risk relating to RPEs is systematic, reducing network companies’ exposure to it should lower network companies’ cost of capital.”³²

²⁸ “Review of the RIIO framework and RIIO-1 performance”, page 7.

²⁹ The British Gas response to “Consultation on mid-period review parallel work”: https://www.ofgem.gov.uk/system/files/docs/2017/07/bg_response_-_mpr_parallel_work.pdf.

³⁰ For example, see “RIIO-ET1 Annual Report 2016-17”, para 4.11-4.14: https://www.ofgem.gov.uk/system/files/docs/2017/12/riio_transmission_annual_report_2017_final_1.pdf.

³¹ “Review of the RIIO framework and RIIO-1 performance”, page 5.

³² “Review of the RIIO framework and RIIO-1 performance”, page 83.

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

We agree this should be developed as part of the sector-specific methodologies.

Information-revealing devices

Q23 Do you agree with our assessment of IQI?

We agree that there is little evidence that IQI has influenced networks to provide their best view of likely expenditure. This is potentially not unexpected. Assuming the risks of under and over spending are roughly symmetric around a best view of expenditure, bidding at the best view means a company is as likely to overspend as underspend. This may not be desirable for companies. Companies may prefer to guarantee an acceptable return even in the event of an actual overspend.

In practice, this means that companies would try to optimise returns at an expenditure level higher than the best view (i.e. assuming overspend relative to the genuine best view) and so IQI suggests they should bid above the best view. This suggests that the penalty for bidding high is an acceptable cost for the guarantee of certain level of return. This is before considering the potential influence on Ofgem's baseline view of cost, which we agree is also likely to be a contributing factor.

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

We are not convinced that fast-tracking has brought benefits to any sector. The costs of fast tracking in RIIO ED1 are clear. CEPA state that this as £510m³³, in terms of increased allowed revenues for WPD resulting from fast tracking. The benefits are less clear-cut. We believe the incremental improvements between DPCR5 and RIIO-ED1 can be largely ascribed to the networks' understanding of the IQI mechanism improving between the two price controls i.e. there was little incremental impact of fast-tracking. This is consistent with both IQI and fast-tracking providing similar incentive signals.

The benefits of reduced scrutiny (saving time and effort for both the fast-tracked network and Ofgem) seem relatively trivial with the risks of approving an inefficient business plan.

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

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

We believe there are significant risks with fast-tracking, as demonstrated by the WPD settlement, with unclear incremental benefits. Therefore, we do not believe fast-tracking should be retained for any sector.

We accept that it is challenging for Ofgem to form a reliable view of efficient costs that is independent of company business plans. So, it is necessary to include a mechanism that encourages networks to 'truth-tell' or submit ambitious business plans.

³³ "Review of the RIIO framework and RIIO-1 performance", page 68.
Page 16 of 28

If the differential in rewards/penalties is increased (i.e. rewards diminish, or penalties increase, more sharply as plans move away from Ofgem's view of efficient) then IQI should become more effective in encouraging truth-telling. This would be an improvement to the current situation and preferable to removing IQI. We would note that this does not necessarily mean increasing the rewards for a plan viewed as efficient. It could be achieved by increasing the penalties for those networks with plans not viewed as efficient.

We support the removal of interpolation. The calibration of the up-front reward effectively takes into account the impact of interpolation and so interpolation serves no clear purpose. We agree that interpolation makes understanding the incentive properties of the IQI mechanism more complicated.

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

We support improving and simplifying the IQI, with interpolation removed and the differential in rewards/penalties increased for differences in efficiency of plans. Also, the IQI 'breakeven point' should be set at 100 i.e. a company whose bid matches Ofgem's view of efficient costs, would be able to achieve a return equal to the allowed cost of capital, if it were to spend, over the price control period, the amount it had forecast.

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)?

We do not support the retaining of fast-tracking. The key risk of fast-tracking (or potentially to the single business plan incentive) is that the financial benefit is higher than expected. Thus, Ofgem needs to be confident that the costs contained within a business plan are efficient. This should be a hurdle that must be overcome regardless of other more qualitative factors. A second hurdle for these qualitative factors could be beneficial, but a business plan should pass both hurdles and not be subject to an overall assessment that combines the two.

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?

When the IQI is being used, it is unclear why sharing factors increase (i.e. networks retain more of any underspend or overspend) as business plans' assessed efficiency improves. If a company's plan is a genuine best view, the company will not be confident of underspending against the plan and so a high sharing factor increases risk. In the absence of the truth telling incentive properties of the IQI, then companies will have an incentive to over-forecast if this will move the assessment of efficient costs. Consistent with Ofwat's approach³⁴, it would be necessary to decrease sharing factors for underspends for plans that are viewed as less inefficient (and increase sharing factors for overspends) to counter the incentive to over-forecast. Conversely, the downward movement in the assessment of efficient costs from any under-forecasting should counter the incentive of higher sharing factors for underspends.

³⁴ See Ofwat's proposed cost sharing model: <https://www.ofwat.gov.uk/wp-content/uploads/2017/12/Cost-sharing-model-for-publication-FAST.xlsx>.

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?

Upfront financial rewards/penalties are a necessary feature of the IQI.

If the IQI were not to be retained, then an incentive to submit high quality business plans should be retained. This should be made a zero-sum incentive with rewards for those networks with higher quality business plans paid for by penalties from those with lower quality business plans. Transmission companies could be treated as a group for these purposes.

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

We support removing fast-tracking for all sectors.

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 improving and simplifying the IQI, with interpolation removed and the differential in rewards/penalties increased for differences in efficiency of plans. Also, the IQI 'breakeven point' should be set at 100 i.e. a company whose bid matches Ofgem's view of efficient costs, would be able to achieve a return equal to the allowed cost of capital, if it were to spend, over the price control period, the amount it had forecast.

Annual reports/reporting

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

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

The publication of the RIIO Annual Reports has helped bring transparency to company performance. The main improvements that can be made are:

- Publishing the reports in a timely manner to a set timetable.
- Publishing all the raw data used in graphs and tables in the reports.
- Publishing the disaggregated data relating to company performance.

Ofgem should also consider publishing the networks' Regulatory Reporting Packs.

Chapter 7 – Fair returns and financeability

Cost of debt

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

The proposed objectives aim to ensure companies have an incentive to seek efficient financing and that customers bear only the efficient costs. Additionally, we recommend the policy objectives are strengthened by making it explicit companies should not be protected from the consequences of inefficient financing decisions.

Arrangements for remunerating debt costs in previous and current price controls have generally been based on considerations of how a notionally efficient company could efficiently finance its operations. As such, the arrangements were designed to encourage networks to incur only efficient financing costs while allowing latitude to each company to decide how to finance its operations. In instances in which management decisions lead to the incurring of inefficient financing costs, customers should not be required to fund that inefficiency. We recommend a thorough review and assessment of the efficiency of debt held by the networks to identify any individual instances of inefficient financing decisions.

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 assessed each option against the proposed policy objectives and the additional objective we recommend above. We believe option B (fixed allowance for existing debt plus indexation for new debt only) will deliver best value for consumers because it achieves all of these objectives. Separating the treatment of efficient embedded and future debt could result in the construction of a shorter trailing average index for future debt that will more closely reflect prevailing market conditions. This would complement the incentive on companies to obtain efficient financing and would ensure customers do not pay more than efficient future costs.

Careful consideration should be given to how efficient levels of embedded debt costs, including the treatment of debt within a larger ownership Group, can be identified. This is needed to ensure customers pay no more than efficient costs for embedded debt. It should not be assumed actual embedded debt costs are efficient and we recommend a thorough review to identify any individual instances of inefficient financing decisions. Arrangements for remunerating debt costs in previous and current price controls have generally been based on considerations of how a notionally efficient company could efficiently finance its operations. As with future debt, companies should not be protected from the consequences of inefficient financing decisions relating to embedded debt. Also, the CEPA report highlights an issue with the Ofwat (and CAA) approach in that it looks at the cost of embedded debt for the start of the price control, rather than over the PR19 price control³⁵. Such an approach will likely overstate the cost of embedded debt as the high yields over the Global Financial Crisis (2008-10) do not drop out of the embedded debt assessment over the course of the price control. Ofgem would need to take account of this effect in any fixed allowance.

³⁵ “Review of cost of capital ranges for Ofgem’s RIIO-2 for onshore networks”, page 42:
https://www.ofgem.gov.uk/system/files/docs/2018/03/cepa_report_on_baseline_allowed_returns_for_riio-2.pdf.

Option A

Option A (re-calibrate the RIIO-1 indexation policy) could weaken the incentive on companies to obtain efficient financing relative to Option B. The RIIO-1 debt indices were constructed to provide allowances to remunerate both embedded and future debt. However, this approach will have a limited effect on influencing embedded debt costs since those costs have already been incurred. This could have a knock-on effect on companies' approaches to seeking debt in the future. As noted in the consultation, an index that spans materially different interest rate environments may not produce allowances that reflect a fair and reasonable estimate of the actual cost of debt likely to be incurred by a notionally geared, efficient company. Attempts to 'fit' an index to remunerate embedded debt and future debt are unlikely to ensure customers pay no more than the efficient cost of debt.

Option C

We do not support option C (pass-through allowance for debt) is considered because pass-through treatment should be reserved for those cost components that are genuinely beyond the companies control. As highlighted in the CEPA report, companies can influence their debt costs by taking several factors into account such as the timing and the tenor of debt. This suggests debt costs do not qualify for pass-through treatment. Further, if pass-through allowances were provided, the incentive on companies to obtain efficient financing would be significantly weakened. Without this incentive being effective, it is unlikely pass-through allowances would reflect a fair and reasonable estimate of the actual cost of debt likely to be incurred by a notionally geared, efficient company.

It is unlikely this option will deliver best value to customers. The pass-through treatment of debt costs is likely to protect companies if they incur inefficient financing costs. This inefficiency would be borne by customers and, as such, customer would be required to pay more than the efficient cost of debt.

Any indexation of the cost of debt (options A and B), should consider whether an adjustment is required to reflect the observed 'halo effect' – networks being able to outperform the index due to the fundamental nature of regulated utilities. The CEPA review recognises an adjustment to the index value is justified where the rationale for this adjustment can be explained³⁶ and also references Ofwat's PR19 final methodology which involves a downwards adjustment of 15bps to the iBoxx 10yr+ indices to adjust for the outperformance in the sector. As well as existing observed outperformance, any adjustment should also take account of the impact of other measures that may be introduced for RIIO-2. For example, the introduction of a revenue floor would be expected to further reduce debt costs relative to the index.

The CEPA review also highlights the current mismatch between the length of the debt tenor for the iBoxx index (c. 20yrs on average) and the time horizon for breakeven inflation (currently 10yrs)³⁷. This mismatch should be addressed and a 20yr breakeven inflation would seem to provide a better measure for converting the nominal yield into an equivalent real yield.

³⁶ "Review of cost of capital ranges for Ofgem's RIIO-2 for onshore networks", page 35.

³⁷ "Review of cost of capital ranges for Ofgem's RIIO-2 for onshore networks", page 38.

Cost of equity

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

The proposed methodology, including indexation of the risk-free rate, is an improvement on the current approach to determining the costs customers bear to remunerate investors. Indexing the risk-free rate makes building in a premium for potential forecast error unnecessary. This premium has not provided value for customers. We note options for indexing the cost of equity are discussed in the consultation. Regardless of the extent to which the final methodology is based on indexation, the methodology should take account of the allocation of risk between customers and investors. We would expect the transfer of risk away from companies, through the use of volume drivers and other uncertainty mechanisms, to have a downward effect on the cost of equity by lowering the equity beta. The introduction of a failsafe mechanism is also likely to have the effect of lowering the equity beta by increasing the stability and predictability of the rates of return that investors would earn over the price control period (discussed further in our answer to question 45).

Q36 Do you agree it would be desirable to index the cost of equity?

• Do you have views on our proposal for indexation?

In principle, we agree it would be desirable to index the cost of equity. The options presented in the consultation are:

- Indexing the risk-free rate.
- Indexing the risk-free rate with an offsetting adjustment for the total market return (or the equity risk premium).
- Indexing the risk-free rate and the total market return (or the equity risk premium).

At this stage, all options presented should be investigated. However, we note CEPA highlights the difficulty of constructing a robust relationship for an offsetting adjustment between the risk-free rate and the total market return³⁸. The development of such a relationship is likely to require more judgment which could introduce an additional source of forecasting error. It will also be necessary to consider how the downward impact of other mechanisms on the cost of equity can be captured in final approach to remunerating investors.

Financeability

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 this would be a significant change to the regulatory framework, and it could have an impact on companies with large inflation-linked liabilities and on demand from investors with inflation linked liabilities. This approach also seems likely to create further financeability issues in later price controls.

³⁸ "Review of cost of capital ranges for Ofgem's RIIO-2 for onshore networks", page 57.
Page 21 of 28

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

In the first instance, the onus for ensuring financeability should lie with the companies. As highlighted in CEPA's review, there are steps that can be taken by the companies to address financeability concerns and there is an incentive to do so to minimise costs associated with investment grade spread³⁹. If regulatory measures are required to address financeability, it is essential their impact is NPV-neutral from a customer perspective. It is also important to ensure that company or network measures do not have a negative impact on long-term financeability.

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

There may be merit in introducing a revenue floor to protect the ability of companies to service debt. We would expect the existence of a floor to have a downward effect on financing costs as it provides additional security for debt repayments. If introduced, it is necessary to consider how this downward effect can be captured in final approach to remunerating debt costs. It is also necessary to consider how any floor payments are recovered in later years so that customers overall remain NPV-neutral.

Corporation tax

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)?

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

We agree the causes of any variances between tax allowances and taxes actually paid to HMRC should be reviewed. At this early stage, all options should be investigated.

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)?

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

We agree that there should be a move away from RPI. RPI is no longer a formal measure of inflation and so should not be relied upon. The recent report for the UK Regulators, on estimating the cost of capital, notes that there is a strong argument for using the measure of inflation chosen by HM Treasury and used by the Bank of England for inflation target setting⁴⁰. This is a sensible default position for RIIO-2.

In practical terms, our understanding is the CPIH may have advantages as it is more commonly used when issuing debt. As CPIH includes housing costs, and so is sensitive to interest rates, care should be taken to understand all the elements of the price control that will be affected by changes in interest rates and that there are no unintended consequences.

³⁹ "Review of cost of capital ranges for Ofgem's RIIO-2 for onshore networks", page 68.

⁴⁰ "Estimating the cost of capital for implementation of price controls by UK Regulators", page 30:
<http://www.ukrn.org.uk/wp-content/uploads/2018/03/2018-CoE-Study.pdf>.

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?

We agree the policies for depreciation and asset lives should be retained. We believe the economic lives of assets should be fully reflected in the price control framework. A key element of the RIIO principles is the use of economic asset lives as the basis of the regulatory depreciation period⁴¹.

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?

We agree it is appropriate to review the fast/money split at the business plan submission stage. We note the proportions have broadly reflected the proportions of opex and capex of total expenditure⁴². We recommend the impact of increasing proportions of expenditure on non-traditional solutions is investigated.

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?

We agree providing revenue to compensate for the raising of notional equity is appropriate. However, in the interest of transparency, we recommend an explicit allowance is provided rather than embedding transaction costs in the overall cost of equity.

Ensuring fair returns

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

General

We note that the Framework Consultation has specifically discussed five possible mechanisms:⁴³ a hard cap and floor; discretionary adjustments; constraining total expenditure and output incentives; a RORE sharing factor; and anchoring returns. In our view the first two of these options do not seem appropriate for RIIO-2, noting the impact they may have on incentives for the energy networks to improve performance and on the risk profile (and cost of capital) of the sector, respectively. The third option does not appear to be a “failsafe” mechanism to us, rather a way of designing the incentive packages, and in any case could be thought of as a special case of the RORE sharing factor. We therefore focus our discussion on options 4 and 5.

We support the introduction of a failsafe mechanism. Our preference is for anchoring to be used in the distribution sectors and RORE sharing in the transmission sectors.

It should be noted that if other options to improve arrangements are implemented then the chance of a failsafe mechanism becoming active is significantly reduced. Such improvements are:

⁴¹ “Decision letter on the regulatory asset lives for electricity distribution assets”, page 3:
https://www.ofgem.gov.uk/sites/default/files/docs/2011/03/assetlivedecision_0.pdf.

⁴² For example, see “Decision on strategy for the next transmission and gas distribution price controls - RIIO-T1 and GD1 Financial issues”, para 7.12:
https://www.ofgem.gov.uk/sites/default/files/docs/2011/03/gd1decisionfinance_0.pdf.

⁴³ Consultation document, page 103.

- Indexation should be employed whenever appropriate
- Similarly, volume drivers should apply to allowances to automatically adjust to changes in circumstances
- Incentive targets should be set to reward relative performance, either on a zero-sum basis or with rolling targets that update as performance is revealed

In particular, it should be less likely that sectoral performance exceeds acceptable bounds (triggering anchoring) than for an individual company (triggering RORE sharing) – although we accept this depends on how the mechanisms are calibrated.

Given this, all parties should welcome the introduction of a failsafe mechanism as it aids improving, and demonstrating, legitimacy. As Ofgem consult upon the parameters for a failsafe mechanism this will allow for a full and transparent discussion about what constitutes a fair return for companies of this nature. This should make it much easier to justify the legitimacy of actual returns. This is especially true for anchoring which also ensures sectoral performance stays within the range viewed as fair.

By restraining the amount by which rates of return can deviate from the allowed cost of equity, both failsafe mechanisms increase the stability and predictability of the rates of return (measured by RORE) that investors would earn over the price control period. Assuming this is to be reflected in the systematic risk of the sector (and therefore beta estimates), the actual cost of equity of the sector should be lower if these mechanisms are introduced.

Comparison of anchoring and RORE sharing

To the extent that the failsafe mechanisms would help to ensure that the rates of return earned by investors (as measured via RORE) were less likely to significantly exceed the returns assessed as fair, the mechanisms would likely increase customer legitimacy. In this respect, we consider the advantages and disadvantages of anchoring and RORE sharing factor include the following:

- Anchoring is a true failsafe mechanism in that sector average RORE would be guaranteed to fall within a range for cost of equity that Ofgem has assessed as fair. The RoRE sharing factor does not provide the same level of protection as it would still be possible for all networks to outperform.
- Additionally, we believe the question of legitimacy arises from the *general* ability of networks to outperform and not that of the best performing networks receiving high returns. Under RORE sharing, the best performing networks could see returns reduced without justification.
- Both failsafe mechanisms would lead to customers and bill payers paying more if the sector is underperforming.
- Both manage the risk of an individual network receiving an unjustified generous settlement. Currently, customers fully bear that risk. Under RORE sharing, customers would still bear that risk only at a reduced level. Under anchoring, the risk is moved to the other network companies. Risk should be placed on the parties most able to manage it. This is clearly the other network companies, who have the opportunity and capability to ensure a fair settlement for all networks. This supports anchoring.

Simply by introducing these failsafe mechanisms there could be an impact on the risk profile of the sector or on the behaviour of the energy networks. We consider that the possible impact on the cost of capital could include:

- By restraining the amount by which rates of return can deviate from the allowed cost of equity, both failsafe mechanisms arguably increase the stability and predictability of the rates of return (measured by RORE) that investors would earn over the price control period. Assuming this is to be reflected in the systematic risk of the sector (and therefore beta estimates), the actual cost of equity of the sector might be lower if these mechanisms are introduced.
- To the extent that the effect of RORE sharing factor on a network company's returns will be easier for that company to predict than the effect of anchoring (which depends more directly on the performance of other energy networks), a case might be made that the RORE sharing factor mechanism reduces risk further than anchoring. On the other hand, anchoring provides a stronger level of restraint on returns, and so more effectively limits the deviations of actual rates of return from the allowed cost of equity (and therefore reduce betas further than RORE sharing factor).
- Anchoring of returns, because its impact depends on factors which investors in a particular network have reduced ability to forecast (e.g. the performance of other network companies), might be argued to increase volatility and unpredictability of returns. The risk of investing in an energy network subject to an anchoring mechanism might therefore be perceived to be higher. These risks should be diversifiable however.

Overall, while it is difficult to judge qualitatively which of the failsafe mechanisms would be likely to reduce the networks' cost of capital by the most, our initial view is that if the impact of both mechanisms is smoothed throughout the price control period, and that energy network companies would have visibility of each other's rates of return and forecast rates of return, then the impact of both mechanisms in any given year should be reasonably predictable. And accordingly, the narrower range of potential outturn rates of return possible under an anchoring mechanism might therefore deliver a larger reduction in the cost of capital than under a RORE sharing factor mechanism.

The failsafe mechanisms may have an impact on companies' incentives. The impact the mechanism would have would depend on whether it was expected to be active or not:

- if a network did not expect RORE (its own for RORE sharing and the sectoral average for anchoring) to fall outside the threshold ranges, then the presence of the mechanism would not influence the company's behaviour.
- this is harder to predict for anchoring (in comparison to RORE sharing) because it would depend on the performance of other energy networks, but is also less likely (as it requires outperformance at a sectoral level rather than an individual network).
- if a network expected its RORE to exceed the threshold (or was unsure), then that company might be expected to take the additional RORE sharing factor into account when deciding on whether to try and outperform by more.
- if networks assume that the industry is likely to outperform beyond the range on average, and anchoring would be triggered, then the networks can anticipate a negative adjustment to revenues via the anchoring mechanism. The networks could translate that adjustment into an equivalent of the RORE sharing factor i.e. some percentage of any further outperformance that they would be able to retain.
- Unlike RORE sharing, however, whilst the marginal incentive may be weaker, networks do not have the option to 'stand still' if anchoring has been triggered. If a network chooses not to strive for further outperformance it is likely to see its absolute level of returns reduce as other networks continue to improve. This may not be acceptable to shareholders,

creating a competitive dynamic between networks – the need to ‘run to standstill’ as in a competitive market.

It should also be noted that the presence of a failsafe mechanism may allow other elements of the price control design to be altered. For example, a number of incentive schemes currently have cap/collar arrangements to limit rewards/penalties. Potentially caps could be relaxed as the failsafe mechanism would be relied upon to capture any excessive or unjustified incentive payments. This means failsafe mechanisms have the potential to improve the incentive to outperform compared the current situation. For example, in RIIO-ED1 a number of DNOs are either beyond, or close to, the performance level where rewards are capped. These means these DNOs have no, or weaker, incentives to improve performance. These caps may no longer be necessary if anchoring was in place.

There are advantages and disadvantages to each of the two failsafe mechanisms, so practical considerations around their application may be important. We note:

- if anchoring was applied to gas transmission, it would amount to ‘rate of return’ regulation and remove any incentives for NGG to outperform the price control allowances. Accordingly, either gas transmission would need to be grouped with another sector for the purposes of anchoring, which do not view as appropriate, or a RORE sharing factor mechanism applied.
- in electricity transmission, while this problem would not be as acute, it may still be an issue. This would be particularly true if the industry average is calculated as a weighted average across the sector, since NGET is substantially larger than SPTL and SHETL combined. So, we believe RORE sharing should be applied for electricity transmission (as with gas transmission).
- anchoring may work better in gas and electricity distribution sectors, where the presence of more licensees (and owners of groups of licensees) means that the failsafe mechanism would not collapse back to ‘rate of return’ regulation and the lower ability of the energy networks within the sector to influence the industry’s average performance, and the need to ‘run to standstill’ would mean that they had a stronger incentive to perform well.

Chapter 8 – Next Steps

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?

Electricity

Modifications to the RIIO framework are needed to accommodate changes in the market to allow local flexibility markets to be developed, to complement the centrally procured flexibility services offered by the TSO/National Grid, allowing local level (distributed generation) to be effectively leveraged. The framework needs to support whole system outcomes, whilst allowing providers the freedom to access the markets where their flexibility is valued most.

This would involve providers of flexibility services sharing local data with DNOs and TSOs which could also include data on site specific constraints, where local flexibility solutions would offer a cost-effective alternative to capital investment in grid re-enforcement. DNOs should also be obliged to share data (historic, near real time and forecast) on local constraints and network needs so that flexibility providers know where and when their services are needed. This could be a minimum standard under ED2.

Increasing volumes of distributed and local generation also have implications for the charging arrangements for networks. Network operators frequently do not have good quality data about behind-the-meter generation or constraints on their own networks. The development of a system with successful distribution level network flexibility requires better quality data and DNOs should be encouraged to both invest in better monitoring of their LV networks and enter arrangements with market participants who can improve the DNO's visibility of their network.

Electricity Distribution

In electricity distribution, care should be taken to ensure that non-firm connection agreements are not used to undermine the commercial incentive for the procurement of flexibility services on the open market. While non-firm connections might be cost-free network management solutions for the DSO, they are not cost free to generators or load, and are inefficient from a whole-systems perspective.

The ability for flexibility providers to be able to connect in reasonable timescales is important. It may be that new outputs will be required.

Gas Transmission

In gas transmission, the setting of baseline capacities is likely to be an important issue. It will be important that stakeholders are involved at every stage of the process. This is also a good example of an issue that a dedicated stakeholder working group looking at the detailed elements of price control could add value to. It is also essential for Ofgem to ensure that all material RIIO-2 proposals are issued in draft for consultation before they are finalised. This has not always been the case in the past, e.g. the last revision to gas transmission entry baselines which took effect in April 2008. We highlight this point as it is widely expected that baselines (which were unamended as from April 2013) will need further revision as from 2021. They are an integral part of the gas transmission price control package.

We believe Ofgem should introduce in the next price control review a regular process to review allowed revenues related to pipelines and other network infrastructure upgrades to meet capacity obligations related to projects that are not built and no actual capacity is provided by the Transporter. This is to avoid that undue costs are borne by network users and consumers. The process should allow alternatively shippers to amend their capacity commitments e.g. with substituted capacity for instance, where available.

Under normal circumstances the shipper/project proposer must commit to acquire long term capacity in order to obtain financing. However, in cases where the project is not built e.g. a storage field, the current framework does not allow a review of the capacity commitments, despite the Transporter not building any capacity or other network infrastructure. The solution we propose would be more balanced and it would lead the Transporter to act more efficiently.

There are precedents like the decision on Fleetwood entry capacity, for which Ofgem decided to remove £277.5 million from NGGT's allowance and reduce its capacity obligation⁴⁴. This is because no actual capacity was provided, no costs had been incurred or work taken place. Although in this case the removal of the allowed revenue originated from a different issue, the factual problem is the same i.e. capacity not built.

⁴⁴ "Decision on the Fleetwood entry point in gas transmission":

https://www.ofgem.gov.uk/system/files/docs/2017/08/fleetwood_capacity_and_funding_decision.pdf.

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?

A degree of notice is required for significant changes to the level of network charges to help ensure these are reflected reasonably to customers. Equally, charges should accurately reflect the allowed costs of the network. The process used for RIIO-ED1, where revenues for the first year of the price control were fixed at the level in Draft Determinations⁴⁵, should be repeated for RIIO2. It provides a reasonable balance between sufficient notice and charges reflecting costs accurately.

⁴⁵ "The timing of a decision on electricity distribution networks' revenue for 2015-16":
https://www.ofgem.gov.uk/sites/default/files/docs/2013/12/ed1_revenuechange_decision.pdf.
Page 28 of 28