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Submitted electronically to
RIIO-2@ofgem.gov.uk

2nd May 2018

Dear James,

Response to: RIIO-2 Framework

innogy SE is a newly established European Energy company. Formerly part of RWE AG, innogy SE has three business segments: Grid & Infrastructure, Retail and Renewables. The UK is a core territory for both our Retail and Renewables segments.

Please find attached our response to the RIIO-2 Framework Consultation (March 2018). This reflects the views of innogy SE's UK segment: npower and innogy renewables UK Ltd.

We will be happy to meet with Ofgem to discuss further the content of this response.

Yours sincerely,

Nicky White

Nicky White
Network Charging Forecasting Manager
Npower

Innogy SE

INNOGY RESPONSE

GENERAL COMMENTS

Prior to specifically answering the questions in the RIIO-2 Framework Consultation, we are keen to provide some additional general points on how the framework could be amended to improve market transparency and cost reflectivity to customers.

The start of RIIO-2 is a 'cliff edge' for suppliers and consumers, since the level of Allowed Revenue going into Network tariffs will not be known until very late in the process. Suppliers can only price into customer contracts what they know at the time of pricing. Typically they will be pricing customers on 1, 2 or 3 year contracts. Ofgem are indicating that allowed revenues could decrease under RIIO-2; however, the extent of that reduction (5%? 10%? 20?) will not be known until very late in the process (end of 2020 for TNUoS and gas). This means that, unless specific action is taken by Ofgem to address this uncertainty as to the levels of allowed revenues in RIIO-2, suppliers will need to make their own assumptions of allowed revenues when pricing for periods in the new price control. This may result in customers paying too much if actual revenues fall further than suppliers have forecast. This will predominantly affect domestic and smaller business customers who take bundled tariffs.

We believe there are two ways where Ofgem could make changes to the framework to smooth the transition from RIIO-1 to RIIO-2 by providing the market with a more transparent and consistent view of overall revenues.

1. For every Network Operator business plan publication, <u>Ofgem instructs Network Operators to overlay the RIIO-2 methodology and publish, in a standard format, an 'Allowed Revenue' value for every year of the price control.</u> This therefore provides the market with a consistent and accurate view of what the Allowed Revenues would be, should these business plans be approved.

2. <u>Ofgem fix the revenues that go into the first year of RIIO-2 Network Tariffs ahead of the Final Determination Date. Any adjustments to this (positive or negative) once the actual Allowed Revenues are confirmed are spread over the remaining years of the price control.</u> This is not a new concept. This approach was previously implemented by Ofgem prior to RIIO-ED1 when revenues to be used for tariff purposes were fixed in July prior to final determination.

   https://www.ofgem.gov.uk/sites/default/files/docs/decisions/ed1_revenuechange_decision.pdf

   For RIIO-2, we would suggest that the revenues to be used for the first year's tariffs are locked down at least 16 months prior to the start of the price control. This will therefore allow suppliers, after that lock down date, to more accurately forecast network tariffs for any contracts spanning 2021/22 since they know the revenue being applied to the charging methodologies. Consumer prices will therefore be more reflective of the actual network costs charged to suppliers. These timelines are also consistent with the current 15 months' notice of DUoS tariffs provided (we do not believe the proposed RIIO-2 timescales should result in a derogation to change the approved current DNO 15 month notice period).

   We would also urge Ofgem to consider extending approach 2 for future years of RIIO-2, in line with the proposals in CUSC modification CMP286.

RIIO-2 Framework Consultation March 2018

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?

RIIO-1 improved the way that Network Operators engaged with end consumers. We agree that it is important to strengthen the consumer voice in the development of business plans and price control decisions. However, the ability of Network Operators to do this is more likely to be limited to dealing with consumer bodies, larger consumers, local authorities and local interest groups.

In the Ofgem SCR Launch Statement (4th August 2017), Ofgem have recognised that 'as network charges are not directly levied on most end-consumers, we think that fairness of network charges to suppliers can be seen as a proxy for fairness to consumers'. In line with this approach, we would suggest that suppliers should also be regarded as a key customer voice in the business plan development / price control decision making process.

We are very supportive of the opportunity to contribute to the newly proposed Customer Engagement / User Groups. We welcome public visibility of companies' business plans ahead of Ofgem's assessment. We do however have some concerns around the resourcing requirements given the large number of intended user groups for the industry. We would suggest that some consideration is given to how this could be reduced. Otherwise, it is likely that larger companies will see greater attendance than smaller ones (e.g. more attendees for Cadent than the other gas GDNs). Engagement is likely to be from the larger suppliers who can resource some (if not all) the proposed events.

We note Ofgem's supporting publication 'RIIO-2 Enhanced Stakeholder Engagement Guidance' and, RIIO-2 framework chapter 3, the intention to work with industry to set up these groups immediately. To facilitate enhanced stakeholder engagement, we request that this live document is updated (perhaps in the Annex) to provide contacts for each of the companies to allow stakeholders to put forward representatives for potential membership of the groups as soon as possible.

We agree that it is necessary for network operators to receive constructive/usable feedback from users of the network. However, we do have some concerns around the difficulty of ensuring that the makeup of these Groups delivers the intended aims, as stated in section 1.7. How can Network Operators ensure that groups across all networks are resourced well with representatives of appropriate expertise? Will representatives really be objective or just represent their own local views?

Given that research has shown existing consumer groups have struggled with necessary knowledge to effectively contribute to the sessions, we believe it is therefore important to ensure that these groups will have an adequate level of industry knowledge across a wide range of subjects. It is also important to recognise that few representatives will have the technical and/or personal skills to effectively challenge network plans. This is the role of Ofgem and it cannot be delegated to the user groups. Effective user groups require a balance of different customer representatives covering the interests of both small and larger users.

Another approach could be that independent auditors, possibly with knowledge of energy industry/network companies, could be appointed to review network plans. This focus on areas of challenge could prove better value to the end consumer.

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?

We support the decision to set a price control length of five years. A longer period would not be appropriate due to changing nature of how the network is used. We support setting some allowances for a longer period if there is a particularly strong case for doing so. However, unexpected cost adjustments at short notice should be avoided.

The period of notice for the annual iteration process (AIP) should be extended to provide greater notice of the incremental change on base revenues (MOD term adjustments). Ideally we would like the TOs to follow the lead of the DNOs and commit to a business plan an additional year ahead of delivery. This would mean the Mod term being set in November Year Y would be for Tariff Year Y+2/+3 rather than Tariff Year Y+1/+2 as is currently the case. For example, AIP in November 2017 calculated the MOD term to apply in relevant year 2018/19 and we are proposing that the AIP in November 2021 would calculate the MOD term for 2023/24.

Ofgem may wish to consider implementation of a 'rolling price control'. As one year reaches completion through the price control, Network Operators publish business plans for future years. The detail behind this (e.g. what is agreed and when) would need to be looked at. However, the benefit of this approach is that it provides more continuity. In addition, customers and the industry are not faced with a 'cliff edge' every time a new price control is due. In addition, we would be supportive of measures to incentivise whole system planning for the period beyond five years (please see our response to Q3-5 for more detail).

Please also see our general comments on Page 2 of this response regarding suggested changes prior to the start of RIIO-2 which would smooth the transition from RIIO-1 and allow suppliers to more accurately predict and reflect the costs into customer contracts.

Whole system outcomes (Q3-5)

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

While we agree that it is important that network companies deliver the value for money services that customers want and/or need, this overarching objective does not provide scope to ensure that these are the right services. We believe RIIO-2 should minimise costs for both todays and future customers. It is about investing in a secure network that is able to meet the challenges and changes moving forward.

RIIO-2 should be designed to ensure that the whole system is considered and that decisions taken in one part of the network do not have a detrimental impact on another part. RIIO-2 should also provide a mechanism for a more holistic system approach. For example, lack of investment in certain areas of the transmission network (thereby not leading to increased TNUoS expenditure) is found to lead to an increase in BSUoS costs as a result of larger local constraints. The outcome is sub-optimal from a whole system point of view and leads to higher total costs for the consumer. We would encourage Ofgem to implement some over-arching objectives across network companies to ensure such circumstances do not arise.

All distribution, transmission network and system operators should continue to be encouraged to share proposals and plans for network developments. As the system becomes more decentralised, with increasing volumes of local generation, it may often be the case that issues on one part of the network could be more efficiently relieved by action by another network operator. All network operators should continue to be incentivised to find the cheapest solution for the end-user, rather than for just their network.

Little consideration seems to be given in the RIIO-2 Framework Consultation to the area of DSOs and the work being undertaken by the ENA Open Networks Project. We would suggest that, even if the detail at this stage is unclear, RIIO-2 should have a mechanism in the framework to be able to pick this up as this activity becomes more prevalent within the price control period. Depending upon which party(ies) are ultimately to have DSO functions in the future there may be need to expand either the price control frameworks of the network companies or that of the Transmission System Operator. DSO functions must offer efficiencies and remove costs elsewhere in order to be value for money. 'New' costs should not be introduced where they have no overall system benefit.

Low-carbon technologies are now the cheapest form of generation and can supply a range of system services. The price controls should enable quicker connections for technologies to connect to the transmission and distribution networks and end-users would benefit from renewable technologies being permitted to compete in technology neutral capacity and ancillary markets.

If networks choose not to do work that is outlined in the business plan then this is not necessarily a saving through better management of the network if the work is simply delayed. There should be a process under RIIO-2 to allow Ofgem to retrospectively remove the cost of this work from the original business plan numbers.

The RIIO-2 process should not lose sight of the role that Network Operators need to do. The framework should be kept as simple as possible in order to ensure that network operators are rewarded for doing their job i.e. ensuring a safe, reliable Network that meets the needs of consumers.

While we recognise that the system is rapidly changing and there are many unknown factors influencing that, we feel that Ofgem should maintain an evolving view of whole system development over the coming decades. This should enable a strategy on future Transmission and Distribution Network development. The government's objectives regarding growth of offshore windfarms should be published along with an indication of what this means in terms of Future TOs. This would enable the most appropriate and efficient planning of TO expenditure in future years.

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?

Yes. We agree that retaining the current start dates for electricity transmission and electricity distribution price controls is better than having all of them aligned. Aligning the price controls would serve to further increase the uncertainty and could lead to increase costs to the end consumer. We would suggest that it may even be better to split the price controls further e.g. gas first, transmission next and then distribution price controls? This would reduce the risk of coincident large changes to consumers.

(It could be considered a distraction of effort to align price controls at this point in time given other major current activities.)

Please also see our general comments on Page 2 of this response regarding suggested changes prior to the start of RIIO-2. In particular, setting revenues to be recovered through tariffs early gives transparency and increased predictability to suppliers when setting prices, thereby reducing risk premia and therefore costs to consumers. This would allow DNOs to continue to provide 15 months' notice of tariffs.

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?

We fully agree that RIIO-2 should be looking at the whole system and the changes that occur during the price control period. This should include areas such as electric vehicles, decarbonisation of heat and the transition of DNOs to DSOs. The timing of such events is uncertain and the price control framework needs to have flexibility to cope with those changes. At the same time, Network Operators should be monitoring these changes either individually and/or as a group over the course of the price control, being proactive in identifying work that needs done. These changes should not result in sudden price shocks for consumers. We recognise consumer uptake of storage and EVs will impact RIIO-2, but uptake will be influenced by Government policy. Therefore a longer term view would be welcomed by the industry based on the government's strategy on policy making.

Whole system approach and network incentives in RIIO-2 should explicitly support a grid carbon intensity that aligns with the fifth carbon budget. It is worth noting that the beginning of the fifth carbon budget coincides with the end of the proposed 5-year ED-2 price control and therefore a huge amount of change will have to be delivered within the RIIO-2 price control period.

System Operator price controls (Q6-8)

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 SO and TO should have separate price control. However, Ofgem need to ensure that costs for SO/TO are considered as total impact on the customers (e.g. low investment in transmission networks could lead to increased constraints and unacceptable increased BSUoS costs to the consumer).

We note that SO price control is not related to constraint portion of BSUoS costs, only the stable internal cost element. Therefore Ofgem should consider whether constraint costs should be brought into the SO price control, based on TO plans, development plans of offshore wind generation /OFTOs and holistic overview of future network development – see also Whole System Outcome comment on Q3.

(As our response to Q3) Little consideration seems to be given in the RIIO-2 Framework Consultation to the area of DSOs and the work being undertaken by the ENA Open Networks Project. We would suggest that, even if the detail at this stage is unclear, RIIO-2 should have a mechanism in the framework to be able to pick this up as this activity becomes more prevalent within the price control period, particularly given the consideration already underway reviewing the different roles, and therefore costs, associated with a distribution system operator role (compared to a distribution network owner role). Depending upon which party(ies) are ultimately to have DSO functions in the future there may be need to expand either the price control frameworks of the network companies or that of the Transmission System Operator. DSO functions must offer efficiencies and remove costs elsewhere in order to be value for money. 'New' costs should not be introduced where they have no overall system benefit.

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

We agree that an appropriate remuneration model for SO's internal costs should be a movement away from providing a return on RAV and could instead move towards remuneration for reasonable costs plus a profit margin.

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

We do not have strong views on this area. However, it seems lower priority than many of the other issues being discussed.

Network utilisation, stranding and investment risk (Q9)

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 do not have strong views on this area.

End-use energy efficiency (Q10)

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?

We believe the approach to this should be defined by Ofgem. It is important that customers are not being bombarded by different parties encouraging them to reduce energy. The approach should be co-ordinated and targeted through the most appropriate channel.

For specific areas with identified or likely areas of constraint, information should be made available and tenders / procurement for services to reduce constraint etc. This will assist market participants to address the issue.

Chapter 5 – Driving innovation and efficiency

Innovation (Q11-15)

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 are supportive of Ofgem pushing network companies to innovate whilst ensuring financiability. Innovation, to some extent, will be natural in the economy as technologies, efficiencies and processes advance over time. We are supportive of approaches to separate 'savings' that should be considered as 'business as usual' and true network innovation. Higher returns are justified when companies find new, more efficient ways of operating their networks through innovation. However, removal of outperformance due to other factors is essential to reward true innovation and reduces overall costs to 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)?

Generally yes. However, innovation needs to be clearly defined as activity that is above and beyond 'day job'. And once implemented, it becomes a business as usual activity. If an innovative technique is introduced by one Network Operator and can be used by another, this knowledge should be shared. The same innovation should not be rewarded more than once.

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?

As above for Q12&13. Innovation needs to be clearly defined as an activity that is above and beyond 'day job' and should be rewarded once only.

Q14. What form could the innovation funding take.

We believe Ofgem are best placed to decide this.

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?

As above for Q12&13, innovation should be defined as above and beyond day job. It should be rewarded once only and then move into BAU. Ofgem should ensure processes are in place to ensure that this happens. Knowledge gained through innovation should be shared across other network operators and implemented as a BAU activity.

Competition (Q16-18)

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

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

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

(Our response covers Q16-18)

We are supportive of the proposal to extend the role of competition across the sectors. However it is important to measure quality as well as cost to the consumer. There is often a focus on reducing costs without assessing the associated impacts on value for money. There becomes a price for all goods and services where the value of those goods to the consumer is optimum and Ofgem should focus as much on the longer term value of an asset or product as they do on driving down costs through competition. The consumers of tomorrow should not be penalised for outcomes which do not offer longer term value for money, but instead merely offered short-term cheapness for the consumers of today.

For example: (consistent with our response to the consultation on 'Income Adjusting Event policy in Offshore Transmission Licences') the OFTO regime has loaded disproportionate risk and cost onto offshore developers, without them having the ability to mitigate and/or manage that risk or recover those costs. Ofgem's allocation of risk onto Developers could have the consequence of raising the cost of capital for future OFTO-connected projects, and ultimately the cost of energy for consumers.

We support Ofgem's drawing of experience from other competitive regimes. We would not want to see Ofgem adopt any of those regimes without first undertaking a critical assessment of the benefits and disbenefits of each element of those regimes. Only through such an analytical approach is it possible for Ofgem to ensure that the parts of competitive regimes that have worked well for the consumer and the regime stakeholders are retained whilst other elements are improved or de-scoped.

Extending competition also raises questions about who is and should be responsible for managing network issues and on what basis these competitions should be run. Whole system outcomes should be the most important factor. For example, a DSO may run a competitive tender to address network constraint, with various solutions such as network reinforcement, storage or distributed generation coming forward. These would all have very different impacts on the network infrastructure, its management and, ultimately, cost to consumer. Only in the first case would it be the ongoing role of the network/system operator to manage, increasing the asset base and asset revenues, but storage may be the best solution from a whole system approach.

Chapter 6 – Simplifying the price controls

Our approach to setting outputs (Q19)

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

The outputs need to be fit for purpose. In some cases, we agree this can be a fairly simple process. However, as illustrated in 6.8, if there are reasons for network operators not to undertake work outlined in their business plan (e.g. change in government policy) there needs to be a much more detailed mechanism to understand why the work has not been undertaken and the 'savings', or more accurately 'underspend', removed accordingly. We recognise the wide range of scenarios that could be covered by this, and the difficulties in having a single approach. There needs to be a sound understanding by Ofgem of why such work has not taken place and a reporting mechanism there to capture that.

Our approach to setting cost allowances (Q20-22)

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

The uncertainty mechanism allows Ofgem to remove or include external influences (volume, revenue triggers, reopeners etc.). However, it is important to recognise that these changes need to be announced to the market with sufficient notice for suppliers to pass such changes into consumer contracts at the time of next reprice. Without this notice period, customers on non-pass through contracts will not receive the benefits that they should receive (or costs if charges go up). Given that suppliers generally price customers on 1, 2 or 3 year contracts, and that DNOs have a 15 month notice period for charges, we would suggest that timescales of changes are 15 months – 2 years ahead of tariff start dates. This could be done via a k-factor type approach (currently 2 years).

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

We agree that RPEs should be indexed since this resolves one of the issues under RIIO-1. In addition, we would like to see further information around the volume drivers proposed in the framework (6.28). As with our response to Q20, there needs to be visibility and adequate notice to the market to allow suppliers to reflect these changes into contracts.

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?

We are not close enough to this to comment.

Information revealing devices (Q23-30)

Q23. Do you agree with our assessment of IQI?

We are concerned that Ofgem are accepting the information asymmetry between Network Companies and Ofgem (6.34). There are ways to address this balance e.g. Ofgem recruiting auditors or recruiting consultants who are familiar with the data that Network Companies hold.

We believe that severe penalty measures should be taken if companies are consistently over-forecasting costs without justification. This is an unacceptable situation.

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

Given companies have all been through the RIIO-1 process, and some companies were fast tracked, it demonstrates that it is possible for companies to produce well justified business plans earlier in the process.

We do not believe that plans should be agreed only a few months prior to tariff start date. There are ways around this (please see our general comments regarding fixing revenues for the first year of RIIO-2 tariffs earlier in the process). We accept there are inherent differences between transmission and distribution networks, and we therefore support the proposals contained in option 3 (single business plan incentive) for distribution companies.

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

Management of (and minimising) potential future excessive profits for Network Companies is essential for RIIO-2. The framework must provide penalties for consistent overstatement of expenditure. IQI or some equivalent is helpful. However, more stringent measures should be available to Ofgem if companies are clearly providing inflated forecasts to set budgets, thereby resulting in profits due to underspend. There needs to be a simple, pragmatic approach to this. If companies are underspending against plan, Ofgem should be reviewing why this is, on a case by case basis and allowances removed if this has been caused by over-forecast. Severe penalties should also be introduced on companies who have consistently over forecast their costs. This would encourage companies to forecast as accurately as possible.

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)?

As previously mentioned in Q1, we believe Ofgem should consider the use of independent auditors / consultants familiar with building Network Operator business plans in order to sense check the numbers in plan. Are there large changes to RIIO-1 actual expenditure? If so, are the reasons for this justifiable?

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?

We believe this is one for Ofgem to consider.

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?

Companies should provide high quality business plans as standard. They have been through the RIIO process before and should therefore be familiar with the practice. We would suggest that penalties should be in place for those companies not providing high quality business plans rather than providing additional incentives. Best practice ought to ensure that all network companies are working to improve their performance not simply because there is are added incentives to do it. In order to do that, Ofgem need to be very clear about the requirements for this. Penalties should also be able to be implemented during the price control if it is seen that business plans are not appropriate given the information available at the time of preparation.

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

Fast tracking had significant benefits to the market in that allowed revenues were fixed much earlier in the process. This meant that suppliers had more certainty around the overall level of the costs and could more accurately price this into customer contracts. We would be happy to support the removal of fast tracking for Transmission if the revenues to be used for the first year of tariffs were fixed earlier in the process.

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?

As per our responses elsewhere in this section, we would suggest penalties being applied for poor business plans will incentivise improvements.

Annual reports/reporting (Q31-32)

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

As a supplier, we would like to see how variances impact on allowed revenues moving forward. It should provide a clear explanation on the reasons behind significant changes.

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

As a supplier, we would like to see how variances impact on allowed revenues moving forward. It should provide a clear explanation on the reasons behind significant changes.

While the Price control needs to be fixed, we feel the business plans of Transmission Operators (TOs) could be used to provide better forward looking view of costs for other market participants, with an optimal time horizon of 7 years. This can be independent of the Price control, although should give a consistent message for any period of overlap. Low, Medium and High views of expenditure (specified in terms of likelihood of occurring, for example 1 in 10 years) could be turned into a view of Allowable Revenue (AR) so long as the assumptions were published alongside. These assumptions may include variables still to be set, such as cost of debt, inclusion or exclusion of specified large expenditure items, and breakdown of overall expenditure. Sensitivities to spend, such as large projects or Strategic Wider Works (SWW), could have individual associated AR sensitivities. We feel this transparency to future costs would lead to more consistent costs estimates to parties exposed to TO costs and thus more efficient competition. This would also give Ofgem clearer notice of expectations in the subsequent Price Control, more time to challenge and understand the assumptions, and therefore a better opportunity to ensure all future plans are consistent with their longer term vision for the future. (See Whole System Outcomes for further detail.)

Chapter 7 – Fair returns and financeability

Cost of debt (Q33-34)

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

We agree that consumers should pay no more than an efficient cost of debt. The calculation should be simple and transparent while providing adequate protection for consumers.

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 prefer Option B since this takes account of historical debt as well as providing an incentive for network companies to out-perform for debt during the price control.

Cost of equity (Q35-36)

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

Yes we agree with this approach.

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

Yes we agree with this approach.

Financeability (Q37-39)

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 would suggest that is for Ofgem to decide on the best approach for this.

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

We would suggest that is for Ofgem to decide on the best approach for this.

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

We would suggest that is for Ofgem to decide on the best approach for this.

Corporation tax (Q40)

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 would suggest that is for Ofgem to decide on the best approach for this.

Other finance issues (Q41-44)

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)?

We agree that (in line with Government's use of CPI for benefits, pensions etc.) that using the CPI would be more reflective of actual costs and would be more consistent.

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?

Not at this stage.

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?

Not at this stage.

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 would suggest that is for Ofgem to decide on the best approach for this.

Ensuring fair returns (Q45-46)

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

We fully support the use of different tools and techniques to reduce the risk of forecasting errors or overbidding by companies. It is essential that Ofgem introduce backstop measures to ensure that such low risk regulated monopoly companies are not making excess profits at the expense of consumers. We believe there should be a suite of options available to Ofgem to do this – there is not just one possible option which will fit all. There is a definite need for discretionary adjustments. We would also encourage the use of penalties if network companies are found to be excessively over estimating costs.

To ensure that such financial adjustments can be passed through to customers by suppliers, we would urge Ofgem to consider implementing these in future periods with reasonable notice. As per our general comments on page 2 of this consultation, this should be a minimum of 16 months advance notice to fit in with DNO final tariff publication.

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

We would suggest that is for Ofgem to decide on the best approach for this.

Chapter 8 Next Steps (Q47-50)

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?

Please see response to previous questions.

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

Please see response to previous questions.

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?

Please see response to previous questions.

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?

As previously stated, we have concerns that RIIO-2 is a 'cliff edge' for the market in terms of knowing what the level of charges will be moving forward. Suppliers can only price into contracts information that they know at the time of pricing, or they have to provide their own forecasts. It is concerning that Allowed Revenues will be agreed very late in the process (i.e. the November prior to tariff start date in April). In our general comments at the beginning of this response, we have suggested 2 approaches to improve these unsatisfactory Allowed Revenue publication timescales:

1 For every Network Operator business plan publication, <u>Ofgem instructs Network Operators to overlay the RIIO-2 methodology and publish, in a standard format, an 'Allowed Revenue' value for every year of the price control.</u> This therefore provides the market with a consistent and accurate view of what the Allowed Revenues would be, should these business plans be approved.

2 Ofgem fix the revenues that go into the first year of RIIO-2 Network Tariffs ahead of the Final Determination Date. Any adjustments to this (positive or negative) once the actual Allowed Revenues are confirmed are spread over the remaining years of the price control. This is not a new concept. This approach was previously implemented by Ofgem prior to RIIO-ED1 when revenues to be used for tariff purposes were fixed in July prior to final determination.

https://www.ofgem.gov.uk/sites/default/files/docs/decisions/ed1_revenuechange_decision.pdf

For RIIO-2, we would suggest that the revenues to be used for the first year's tariffs are locked down at least 16 months prior to the start of the price control. This will therefore allow suppliers, after that lock down date, to more accurately forecast network tariffs for any contracts spanning 2021/22 since they know the revenue being applied to the charging methodologies. Consumer prices will therefore be more reflective of the actual network costs charged to suppliers. These timelines are also consistent with the current 15 months' notice of DUoS tariffs provided (we do not believe the proposed RIIO-2 timescales should result in a derogation to change the approved current DNO 15 month notice period).

We would also urge Ofgem to consider extending approach 2 for future years of RIIO-2, in line with the proposals in CUSC modification CMP286.

This will result in giving suppliers the ability to more accurately reflect the costs they will be charged into customer contracts.