GNE Response to RIIO- 2 Framework Consultation

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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?

The trade off between network efficiency and reslinance can in some cases conflict and become what is in effect a matter of public policy. This should form the basis of the conversation with consumers and their networks. Consumer representatives should be empowered to have the discussion on how much they are prepared to pay for a given level of service or resiliance.

In terms of design would want any new regulatory regime to consider some issues raised by behavioural economics that networks might have an incetive to exploit?

- *"Framing" is critical for decision making and critically the way material is presented to customer groups. It appears to us that in PR19 water companies reseracher's are very good explaining to consumers the technical challenges faced by them but were less advanced in the way they presented economic tradeoffs.*
- *Decision making is often contingent on a small number of heuristics. This could be an issue where for example customer minutes lost may average two over the network but some customers may be off supply for a number of hours and others have a largely interrupted supply.*
- *Finally, the value of a service is often only fully recognised with its absence. We therefore suggest controlling for customers who have had a recent outage is an important issue that could tip the balance towards more rather than less new investment.*

→ What are your views on the proposal to have Open Hearings on areas of contention that have been identified by the groups?

GNE welcomes an open hearing approach on issues of contension. This should reduce the chance of appeal. We note the use of hearings in price control is well established, enduring and proven mechanism. In fact "Rates hearings" are a common regulatory practice for example, the California Public Utilities Commission and its predicesors have been using this method since the end of the nineteenth century.

We note that the recruitment of consumer panel members is critical in making the process work. We would prefer networks to recruit consumers who are representative users of their networks over "representatives of representatives".

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 agree that the control should be set for a five year period. Any longer would almost certaintly require an interim review. This is because inflation, demand or technological developments are likely to have an impact on the network over an eight year period.

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

The PR19 water price control is effectively a number of separate controls bundled into one package (e.g. water resspources and supply functions). Following the water example we would suggest there is scope for a longer control for large scale capital projects.

→ How could we mitigate the potential disruption this might cause to the rest of the framework?

There is no potencial disruption if capital intensive special projects are carefully choosen.

→ What additional measures might be required to support longer-term thinking among network companies?

We think that energy networks are almost forced to think in the long term given the asset lifetimes of the network. We would suggest that the underlying issue is more that it is difficult for networks to think strategically in a commercial environment that is rapidly changing.

→ Do you instead support the option of retaining eight-year price controls with a more extensive Mid-Period Review (MPR)?

No we do not support this. The mid year review is likely to be almost identical to a new control or at least a re opener.

→ 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?

No we do not support this measure.

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?

We do no think there are any particular barriers to overcome.

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

It is likely that the elements of the price control that are linked to network operation could be areas where system benefits could exist.

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 agree.

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 would argue that any consideration of whole system benefits should be broadly based on a social welfare test.

→ Are there any implementation limits to this definition?

It would be unlikely for a well established social welfare based definition.

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?

Yes. We think is more consistent with European regulation.

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?

We do not have any suggestions at this time but it is difficult to see how short term balancing is capital intensive. This would strongly suggest option 2. The regulator has to set a control against an organisation with a high dgree of short term fixed costs (e.g. wages and other overheads). This would indicate a cost plus model for this activity.

It would be possible to measure SO performance against a hypothetical dispatch from bid offers in the BM. This could form the basis of an assessment of efficiency with an allowance.

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

→ If so, why and what models?

We do not have any suggestions at this time but as with electricity it is difficult to see how short term balancing is capital intensive. This would strongly suggest option 2. The regulator has to set a control against an organisation with a high degree of short term fixed costs (e.g. wages and other overheads). This would indicate a cost plus model for this activity.

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?

If the direction of travel is to move to more localised generation, the value of the network service moves towards a capacity "option value". In this scenario, the electricity transmission system is effectively the capacity provider of last resort if localised generation is not available. In this case Ofgem economists have to think carefuly about the concepts of redundancy and stranding if the assets are used infrequently. Equally with the wide adoption of EV's then it is unlikely that there will be many redundant assets as demand will have increased as electricity replaces oil for transport and therefore not be a problem.

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?

  The value of energy savings varies between the value of network capacity to the network owner and the commodity value of the electricity saved to the consumer. It is likely that the specific and individualised commodity costs may be larger than more generalised network benefits. If this is the case there may therefore be structural reasons why it might be harder for the network to identify customers that make a significant impact on their netwoks.

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.

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

We agree.

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 would be careful not to be too specific in considering areas for innovation. Too ridgidly defined they are likely to prevent truly innovative activity that may well emerge from technoilogy transfer from other sectors.

Q14. What form could the innovation funding take.

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

We would prefer an approach that created a strong incentive based mechanisms to encourage innovation. This is consistent with the economics of innovation.

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?

It should be obvious what the benefits of information are in terms of the value. If its value canot easily be measured then there is some doubt about its true benefit.

Competition

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

We agree. Competition for the market is an effective solution. One of the qualities that make the networks as natural monopolies is the benefits of scale as it relates to cost. For wires and pipes the issue is that it would be uneconomic to duplicate networks. However in the energy transition, EV's could require a completelty new network for example. We see no reason why this monopoly should automatically go to the existing networks.

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

The trade off is likely to be between expertise in project delivery vs cost.

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 agree with the proposal to implement the criteria (p55)

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?

Precisely defining the scope of work.

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?

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

The setting of targets should be based in some cases on the networks individual characteristics including network density and age of assets. We would therefore argue that absolute targets favour situations when equitable performance comparasons can be made.

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

Resetting targets may well favour customer performance ativities and reliability metrics.

Our approach to setting cost allowances

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

We agree with Ofgem's approach.

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

We agree with the approach noting the difficulties in correctly predicting RPE.

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? Information-revealing devices
With benchmarking inevitably there will be a best and worst performers. Equally there might be a tempatation in the business plans to be over optimistic about a networks performance. Actual cost performance should solve these two issues.

Q23. Do you agree with our assessment of IQI?
We agree.

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

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

- → How might these apply in the different sectors?
- → Should we retain the IQI, amend it or replace it entirely?

In theory the best plan should receive the most reward regardless of a specific incentive structure behind it. However in practice the IQI is probably nessesary. We note that the company with the best business plan may change throughout the course of the control given the changing environment or new issues that come to light during the course of the control.

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 would suggest the ability of the company to credibaly translate customer preferences into an investment program.

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 would expect Ofgem to take account to the differences between networks outside of management control.

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?
As we have stated. In theory the best plan should receive the most reward regardless of the incentive structure behind it.

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

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?
No. We note it may be harder for transmission companies to identify consumer interests than for the DNO's.

Annual reports/reporting
Q31. How can we best improve the suite of annual reporting requirements to be as efficient and useful as possible?
We agree with the suggestions on p74 6.85.

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

Stronger use of thenarrative behind the numbers.

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?
We support the views.

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 could live with options A to C. We would note that if debt was treated as a pass through then it would suggest that it was both random and out of management control.

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

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

- → Do you have views on our proposal for indexation?

  We broadly agree. We would note that a TMR index would obscure some important differences in return for different industries if taken for the market as a whole?

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 see some merit in the proposal.

Q38. Should the onus for ensuring financeability lie with the network operating companies in whole, or in part?
We would suggest in the whole in the same way as the market judges the company.

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

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)?
We agree.

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

We would suggest spot checking group tax relief.

Other finance issues

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 see no compelling evidence to move away from RPI as policy alternatives may not solve the underlying flaws of using RPI.

If yes, which of the two potential indices – CPI or CPIH – might be most suitable?
N/A
Is a phased transition between RPI and the chosen successor index necessary or desirable?
N/A

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?

Ensuring fair returns
Q45. What are your views on each of the options to ensure fair returns we have described in this consultation?
Summary Table 1

Option	Comment
Hard Cap floor	Would be simple to administer but be subject to variation risk. To mitigate this a wider cap and floor would be the logical response but risk enhancing network returns
Discretionary adjusment	Increases regulatory risk for the networks and could be subject to political pressure
RoRE Sharing factor	Seems appealing. Would be relatively simple to administer, but not desining for the sculpted sharing factor.
Constraining totex and output incentives	Would be highly complex and therefore difficult to administer.
Anchoring returns	May be an attractive solution but is a variant on the hard cap floor approach?

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

Yes.

→ Are there other metrics that we should consider, and if so why?
No.

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 sectorspecific proposals?
We have no views at this time.

Q48. Do you have any views on the issues highlighted that we will consider as we develop our sector-specific proposals?
We have no views at this time.

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?
For the electricity controls a firm view on future demand linked to take up of EV's is essencial.

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?
We have no views at this time.